Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Corbett | Analyst: Jeff Garnier | Bill Number: AB 1122

Related Bills: See Legislative History | Telephone: 845-5322 | Amended Date: March 20, 2002

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Conformity Act of 2002

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ________________________.

__X__ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended ________________________.

____ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ________________________.

__X__ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED February 13, 2002 STILL APPLIES.

__X__ OTHER - See comments below.

SUMMARY

This bill would conform state law to federal treatment of the:

1. Pension plan, Coverdell Education Saving Account, and Qualified Tuition Plan changes contained in the federal EGTRRA (explained in the February 13, 2002 analysis).
2. Gifts of appreciated property for alternative minimum tax purposes (explained in the February 13, 2002 analysis).
3. Estimated tax payments of individuals (explained in the February 13, 2002 analysis).
4. Federal S corporation election, requiring corporations with a valid S election for federal law to be an S corporation for California law (explained in the February 13, 2002 analysis).
5. Deduction of club dues. (See explanation on page 2.)
6. Numerous federal changes made between January 1, 1998, and January 1, 2001. (See explanation beginning on page 4.)

SUMMARY OF AMENDMENTS

The March 20, 2002, amendments removed the provisions requiring California elections to be the same as for federal purposes, except for S corporation elections. A corporation with a valid federal S corporation election would still be required to be an S corporation for state purposes.

The March 20, 2002 amendments also added a provision to conform to the 1993 federal change disallowing the deduction of club dues.

Board Position:			Department Director	Date
__X__ S	____ NA	____ NP	Gerald H. Goldberg	04/02/02
____ SA	____ O	____ NAR		
____ N	____ OUA	____ PENDING		

Finally, the March 20, 2002, amendments would conform to numerous federal changes that occurred between January 1, 1998, (the referenced date for the last enacted general conformity legislation) and January 1, 2001.

The remainder of the analysis of the bill as amended February 13, 2002, still applies.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy. Thus, it would be effective immediately, and unless otherwise specified, it would apply to taxable years beginning on or after January 1, 2002. The provisions of this bill that conform to portions of EGTRRA apply to taxable years beginning before January 1, 2011.

This bill would become operative only if SB 657 (Scott) is chaptered.

REVENUE TABLE

Estimated Conformity Impact of AB 1122 As Amended 3/20/02 Enactment Assumed After 6/30/02 ($ in Millions)			
Provision	2002-03	2003-04	2004-05
EGTRRA	-$50	-$87	-$99
AMT on Charitable Contributions of Appreciated Property	-$12	-$10	-$10
Federal Estimate Payment Requirements	$210	$10	$10
Waive Estimated Tax Penalties	No Impact	No Impact	No Impact
Mandated S vs. C Election	$10	$10	$10
Club Dues	$12	$9	$10
Conformity 1998-2000	$5	$20	$18.5
Total	$175	-$48	-$60.5

ANALYSIS

5. CONFORMITY TO THE DENIAL OF CLUB MEMBERSHIP DUES DEDUCTION.

Under federal law, prior to 1993, and current state law, a deduction for club dues was allowable if the taxpayer could establish that the use of the club was primarily for the furtherance of the taxpayer's trade or business and the specific expense was directly related to the active conduct of a trade or business.

In 1990, California limited the deduction for club dues by denying the deduction for any amounts paid to any club that has discriminatory practices. No expense incurred at or paid to a club that restricts membership or the use of services or its facilities based on age, sex, race, religion, color, ancestry, or national origin is deductible.

The federal Revenue Reconciliation Act of 1993 (RRA of 1993) provided that no deduction is permitted for club dues. The prohibition applies to all types of clubs, including business, social, athletic, luncheon, and sporting clubs. Specific business expenses (e.g., meals) incurred at the club are deductible only to the extent they are directly related to the active conduct of the taxpayer's trade or business.

California has not conformed to the 1993 federal change.

THIS BILL

This bill would conform California law to the RRA of 1993 change denying the deduction for club dues. For taxable years beginning in 2002, a deduction for 25% of club dues paid would be allowed. For taxable years beginning in 2003 and thereafter, no deduction for club dues would be allowed. In addition, California law would continue to deny deductions for any amounts paid to clubs engaged in discriminatory practices.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. The review of these states' tax laws indicates that they do not permit the deduction of club dues.

ECONOMIC IMPACT

Revenue Estimate

Estimated Conformity Impact of AB 1122 As Proposed to be Amended			
Enactment Assumed After June 30, 2002			
Fiscal Years			
(In Millions)			
Provision	2002-3	2003-4	2004-5
Club Dues	$7	$9	$10

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

The Revenue estimate is based on a proration of federal estimates.

6. CONFORMITY TO THE 1998, 1999, AND 2000 FEDERAL CHANGES

The Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL), in general, conform to the Internal Revenue Code (IRC or Code) either by incorporating the IRC by reference as of a "specified date" or by stand-alone language that mirrors the federal provision. California law is conformed to the IRC as of January 1, 1998, unless a specific provision provides otherwise. This bill would change the specified date from January 1, 1998, to January 1, 2001, for taxable and income years beginning on or after January 1, 2002. Changing the specified date automatically conforms to all changes from January 1, 1998, through December 31, 2000, to IRC sections that have been previously incorporated by reference. Thus, California law would conform to numerous changes made to federal income tax law since 1998 by the six federal bills that have been enacted into law during that time that materially affect the IRC. They are:

- IRS RESTRUCTURING AND REFORM ACT OF 1998 (IRS Reform Act)
- TAX AND TRADE RELIEF EXTENSION ACT OF 1998 (Tax and Trade Extension Act)
- SURFACE TRANSPORTATION REVENUE ACT 1998 (Transportation Act)
- RICKY RAY HEMOPHILIA RELIEF FUND ACT OF 1998 (Ricky Ray Hemophilia Act)
- TICKET TO WORK AND WORK INCENTIVES IMPROVEMENT ACT OF 1999 (Ticket to Work Act)
- MISCELLANEOUS TRADE AND TECHNICAL CORRECTIONS ACT OF 1999 (Miscellaneous Trade Act)
- CONSOLIDATED APPROPRIATIONS ACT, 2001 (Appropriations Act, 2001, enacted in December of 2000)

This bill also would make numerous changes to specifically not conform to particular federal provisions or to modify the general conformity to certain items in the IRC.

The following is a list of the changes that would be made to California tax law by this bill. For a complete analysis of each item, refer to the corresponding page number below in Appendix III[1].

[1] Information for Appendix III derived from the Joint Committee on Taxation reports.

ECONOMIC IMPACT

Revenue Estimate

Proposed 1998- 2000 Conformity Revenue Estimates
Effective Date January 1, 2002
Enactment after June 30, 2002

	Provisions		Personal Income Tax (in millions)			Corporation Tax (in millions)		
			2002-03	2003-04	2004-05	2002-03	2003-04	2004-05
	Conformity Items							
1	Exclusion from Income for Employer-Provided Transportation Benefits		Insignificant	Insignificant	Insignificant	Insignificant	Insignificant	Insignificant
2	Exclusion of value of meals to employees		-$1	-$1	-$1	-	-	-
3	Employer Deductions for Vacation and Severance Pay	a/	Minor Gain	Minor Gain	Minor Gain	$2	$3	$3
4	Certain Trade Receivables Ineligible for Mark-To-Market Treatment		Minor Gain	Minor Gain	Minor Gain	$12	$18	$10
5	Exclusion-Min. Req. Distributions from AGI for Roth IRA Conversions	b/	-	-	-	-	-	-
6	Farm Production Flexibility Contract Payments		Insignificant	Insignificant	Insignificant	Insignificant	Insignificant	Insignificant
7	Certain Deductible Liquidating Distributions of RICs & REITs	c/	-	-	-	$5	$5	$5
8	Tax Treatment of Cash Options for Qualified Prizes		Minor Loss	Minor Loss	Minor Loss	-	-	-
9	Payments Received Pursuant to the Ricky Ray Hemophilia Relief Fund Act		Insignificant	Insignificant	Insignificant	-	-	-
10	Property Subject to a Liability Treated as Assumption of Liability - P.L. 106-36		-	-	-	$1	$1.5	$1.5
11	Extend Tentative Minimum Tax Relief for Individuals		Negl. Loss	Negl. Loss	Negl. Loss	-	-	-
12	Extend/Expand Expensing of Environmental Remediation Expenditures.	d/	Negl. Loss	Negl. Loss	Negl. Loss	-$10	-$6	-$2
13	Provide that Federal Production Payments to Farmers are Taxable in the Year Received		Negl. Impact	Negl. Impact	Negl. Impact	Negl. Impact	Negl. Impact	Negl. Impact
14	Clarify the Tax Treatment of Income and Losses from Derivatives		Negl. Gain	Negl. Gain	Negl. Gain	Negl. Gain	Negl. Gain	Negl. Gain
15	Expand Reporting of Cancellation of Indebtedness Income		-	-	-	Negl. Gain	Negl. Gain	Negl. Gain
16	Limit conversion of Character of Income from Constructive Ownership Transactions		$1	$1	$1	Negl. Gain	Negl. Gain	Negl. Gain
17	Treatment of Excess Pension Assets Used for Retiree Health Benefits	e/	-	-	-	-	-	-
18	Installment Method Pledge Rules	f/	-	-	-	-	-	-
19	Denial of Charitable Contribution Deduction for Transfers Associated with Split-Dollar Insurance Arrangements		Negl. Gain	Negl. Gain	Negl. Gain	Negl. Gain	Negl. Gain	Negl. Gain

20	Distributions by a Partnership to a Corporate Partner of Stock in Another Corporation		-	-	-	Minor Gain	Minor Gain	Minor Gain
21	Low Income Housing Credit	g/	-	-	-	No Impact	No Impact	No Impact
22	Corporate Donations of Computers		-	-	-	-$6	-$2	Insignificant
23	Medical Savings Accounts		Negl. Loss	Negl. Loss	Negl. Loss	Negl. Loss	Negl. Loss	Negl. Loss
24	Tax Benefits - Kidnapped Children		Negl. Loss	Negl. Loss	Negl. Loss	-	-	-
25	Assumption of Liabilities - Corporations - P.L. 106-554		-	-	-	$1	$0.5	$1
26	Tax Treatment of Securities Futures Contracts		-	-	-	Negl. Impact	Negl. Impact	Negl. Impact
27	Tax Technical Corrections		Negl. Impact	Negl. Impact	Negl. Impact	Negl. Impact	Negl. Impact	Negl. Impact
28	1999 Federal Technical Changes		Insignificant	Insignificant	Insignificant	Insignificant	Insignificant	Insignificant
	TOTALS		-	-	-	$5	$20.0	$18.5

Footnotes.

Negligible = Loss or gain of less than $250,000

Minor = Loss or gain of less than $500,000

a/ Baseline revenue gains are projected to be $3 million annually.

b/ Conformity gains are estimated to be $1 million annually beginning with the fiscal year 2004-5.
Baseline revenue gains are projected to be $84 million for 2004-5, $101 million for 2005-6, and $99 million for 2006-7.

c/ Baseline revenue gains are projected to be $15 million annually.

d/ Includes conformity impact for 2002 and 2003.

e/ Baseline gains from reduced business deductions are estimated at $1 million annually in 2001-2 thru 2004-5.

f/ Baseline revenue gains are projected to be $1 million annually.

g/ The California Tax Allocation Committee already allocates the maximum credit authorizations.

LEGISLATIVE STAFF CONTACT

Jeff Garnier
Franchise Tax Board
845-5322

Brian Putler
Franchise Tax Board
845-6333

Appendix III

1. <u>Exclusion from Income for Employer-Provided Transportation Benefits</u>

Under federal and California laws, qualified transportation fringe benefits provided by an employer are excluded from an employee's gross income. Qualified transportation fringe benefits include parking, transit passes, and vanpool benefits. In addition, in the case of employer-provided parking, no amount is includible in income of an employee merely because the employer offers the employee a choice between cash and employer-provided parking. Under prior federal and current California laws, transit passes and vanpool benefits were excludable only if provided in addition to, and not in lieu of, any compensation otherwise payable to an employee. Up to $155 per month of employer-provided parking was excludable from income. Up to $60 per month of employer-provided transit and vanpool benefits were excludable from gross income. These dollar amounts were indexed annually for inflation, rounded to the nearest multiple of $5.

Under current and prior federal and state laws, qualified transportation fringe benefits include a cash reimbursement by an employer to an employee. However, in the case of transit passes, a cash reimbursement is considered a qualified transportation fringe benefit only if a voucher or similar item which may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee.

Under the Transportation Act, employers are permitted to offer employees a choice between cash compensation or any qualified transportation benefit or a combination of any of such benefits. The amount of cash offered is includible in income and wages only to the extent the employee elects cash. Thus, under the provision, no amount is includible in gross income or wages merely because the employee is offered the choice of cash in lieu of one or more qualified transportation benefits (up to the applicable dollar limit). Also, no amount is includible in income or wages merely because the employee is offered a choice among qualified transportation benefits.

It is intended that salary reduction amounts used to provide qualified transportation benefits under the provision be treated for pension plan purposes the same as other salary reduction contributions.

The Transportation Act increased the exclusion for employer-provided parking to $175 per month and the employer-provided transit and vanpool benefits exclusion to $65 per month. In addition, beginning in 2002, the Transportation Act increases the exclusion for transit passes and vanpooling to $100 per month. Beginning in 2003, the $100 amount is indexed as under prior law. Further, no qualified transportation benefit will be indexed in 1999.

The provision permitting a cash option for any transportation benefit is effective for taxable years beginning after December 31, 1997; the increase in the exclusion for transit passes and vanpooling to $100 per month is effective for taxable years beginning after December 31, 2001; and indexing on the $100 amount for transit passes and vanpooling is effective for taxable years beginning after December 31, 2002.

California Law

Current California law is in full conformity with federal law as it read on January 1, 1998, as it relates to qualified transportation fringe benefits and annual additions to tax-qualified pension plans.

In addition, California law provides that gross income of an employee does not include benefits received for participation in any ridesharing arrangement in California. A ridesharing arrangement includes:

- commuting in a carpool, vanpool, buspool, or taxipool.
- monthly transit passes used by the employee or the employee's dependents, other than dependents attending elementary or secondary school.
- free or subsidized parking.
- commuting by ferry or bicycling.
- travel to or from a telecommuting facility.
- the use of any transportation used to go to or from the place of employment that reduces the use of a motor vehicle occupied by a single person.

This bill would conform California law to the Transportation Act changes to the transportation fringe benefits rules. This bill would not affect the rules relating to California ridesharing arrangements.

2. Deductibility of Meals Provided for the Convenience of the Employer

In general, subject to several exceptions, only 50% of the cost of business meals and entertainment is allowed as a deduction IRC Sec. 274(n)). Under the Tax Relief and Reform Act of 1997 (TRA of 1997) exception, meals excludable from employees' incomes as a de minimis fringe benefit (IRC Sec. 132) are fully deductible by the employer. In addition, the courts have held that if substantially all of the meals are provided for the convenience of the employer pursuant to IRC Sec. 119, the cost of such meals is fully deductible because the employer is treated as operating a de minimis eating facility within the meaning of IRC Sec. 132(e)(2). However, the judicial decisions did not provide a bright line definition of "substantially all," and thus disputes continued between taxpayers and the IRS.

The IRS Reform Act provides a new safe harbor rule for the employee exclusion and the employer deduction. Under that new safe harbor, all meals furnished to employees at the employer’s place of business meet the convenience test under IRC Sec. 119, if more than one-half of employees furnished meals on the premises are furnished such meals for the convenience of the employer. If these conditions are satisfied, the value of all such meals are excludable from the employee's income and fully deductible to the employer. No inference is intended as to whether the cost of such meals are fully deductible under prior law. This provision is effective for all taxable years. The provision is effective for taxable years for which the applicable statute of limitations has not expired.

California Law

California law is in full conformity with federal law as it read on January 1, 1998, as it relates to the deduction of meals provided to employees.

This bill would conform California law with the new federal safe harbor rule as it relates to the deductibility of meals provided by an employer with the same effective date as under federal law.

3. Employer Deductions for Vacation and Severance Pay

Under prior federal and current California laws, for deduction purposes, any method or arrangement that has the effect of a plan deferring the receipt of compensation or other benefits for employees is treated as a deferred compensation plan (IRC Sec. 404(b)). In general, contributions under a deferred compensation plan (other than certain pension, profit-sharing and similar plans) are deductible in the taxable year in which an amount attributable to the contribution is includible in income of the employee, regardless of whether the employee actually receives the benefit during the year. However, vacation pay which is treated as deferred compensation is deductible for the taxable year of the employer in which the vacation pay is paid to the employee (IRC Sec. 404(a)(5)).

Temporary Treasury regulations provide that a plan, method, or arrangement defers the receipt of compensation or benefits if an employee receives compensation or benefits more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed. Compensation received after the 15th day of the third calendar month after the end of the employer's taxable year in which the related services are rendered is considered received after more than a brief period. Compensation or benefits received by the employee on or before the end of the applicable 2 1/2- month period is not deferred compensation. (Temp. Treas. Reg. Sec. 1.404(b)-1T, A-2.)

The Tax Court recently addressed the issue of when vacation pay and severance pay are considered deferred compensation in Schmidt Baking Co., Inc. v. Commissioner (1996) 107 T.C. 271. In Schmidt Baking, the taxpayer was an accrual basis taxpayer with a fiscal year that ended December 28, 1991. The taxpayer funded its accrued vacation and severance pay liabilities for 1991 by purchasing an irrevocable letter of credit on March 13, 1992. The parties stipulated that the letter of credit represented a transfer of a substantially vested interest in property to employees for purposes of Section 83, and that the fair market value of such interest was includible in the employees' gross incomes for 1992 as a result of the transfer. While the rules of Section 83 may govern the income inclusion for employees, Section 404 governs the employer deduction if the amount involved is deferred compensation.

The Tax Court held that the purchase of the letter of credit, and the resulting income inclusion, constituted payment of the vacation and severance pay within the 2 1/2-month period. Thus, the vacation and severance pay were treated as received by the employees within the 2 1/2-month period and were not treated as deferred compensation. The vacation pay and severance pay were deductible by the taxpayer-employer for its 1991 fiscal year pursuant to its normal accrual method of accounting.

The IRS Reform Act provided that for purposes of determining whether an item of compensation is deferred compensation (under IRC Sec. 404), the compensation is not considered to be paid or received until actually received by the employee.

In addition, an item of deferred compensation is not considered paid to an employee until actually received by the employee. The provision is intended to overrule the result in Schmidt Baking. For example, with respect to the determination of whether vacation pay is deferred compensation, the fact that the value of the vacation pay is includible in the income of employees within the applicable 2 1/2-month period is not relevant. Rather, the vacation pay must have been actually received by employees within the 2 1/2-month period for the compensation not to be treated as deferred compensation.

Congress intended that similar arrangements, in addition to the letter of credit approach used in Schmidt Baking, do not constitute actual receipt by the employee, even if there is an income inclusion. Thus, for example, actual receipt does not include the furnishing of a note or letter or other evidence of indebtedness of the taxpayer, regardless of whether the evidence is guaranteed by any other instrument or by any third party. As a further example, actual receipt does not include a promise of the taxpayer to provide service or property in the future (regardless of whether the promise is evidenced by a contract or other written agreement).

In addition, actual receipt does not include an amount transferred as a loan, refundable deposit, or contingent payment. Amounts set aside in a trust for employees generally are not considered to be actually received by the employee.

The provision does not change the rule under which deferred compensation (other than vacation pay and sick pay and deferred compensation under qualified plans) is deductible in the year includible in the gross income of employees participating in the plan if separate accounts are maintained for each employee.

While Schmidt Baking involved only vacation pay and severance pay, there is concern that this type of arrangement may be used to try to circumvent other provisions of the IRC where payment is required in order for a deduction to occur. Thus, Congress expressed its intent that the Secretary will prevent the use of similar arrangements, though no inference was intended that the result in Schmidt Baking is present law beyond its immediate facts or that the use of similar arrangements is permitted under present law.

This provision is effective under federal law for taxable years ending after July 22, 1998. Any change in a taxpayer's method of accounting required by this provision will be treated as initiated by the taxpayer with the consent of the Secretary of the Treasury. Any adjustment required by IRC Sec. 481 as a result of the change will be taken into account for federal purposes over a three-year period beginning with the first year for which the provision is effective.

California Law

Current California law is in full conformity with federal law as it read on January 1, 1998, as it relates to employer deductions for vacation and severance pay.

This bill would conform California law to the federal IRS Reform Act law change as it relates to the accrual of vacation and severance pay. This bill would also require any state adjustment required by IRC Sec.481 as a result of the change to be taken into account over a three-year period beginning with 2002.

4. Certain Trade Receivables Ineligible for Mark-To-Market Treatment

In general, under federal and state laws, dealers in securities are required to use a mark-to-market method of accounting for securities (IRC Sec. 475). Exceptions to the mark-to-market rule are provided for securities held for investment, certain debt instruments and obligations to acquire debt instruments and certain securities that hedge securities. A dealer in securities is a taxpayer who regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or who regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in certain types of securities with customers in the ordinary course of a trade or business.

A security includes (1) a share of stock, (2) an interest in a widely held or publicly traded partnership or trust, (3) an evidence of indebtedness, (4) an interest rate, currency, or equity notional principal contract, (5) an evidence of an interest in, or derivative financial instrument in, any of the foregoing securities, or any currency, including any option, forward contract, short position, or similar financial instrument in such a security or currency, or (6) a position that is an identified hedge with respect to any of the foregoing securities.

The IRS Reform Act provides that certain trade receivables are not eligible for mark-to-market treatment. A trade receivable is covered by the provision if it is a note, bond or debenture arising out of the sale of goods by a person the principal activity of which is selling or providing nonfinancial goods and services and it is held by such person or a related person at all times since it was issued.

Under the IRS Reform Act, a receivable meeting the above definition is not treated as a security for purposes of the mark-to-market rules (IRC Sec. 475). Thus, such receivables are not marked-to-market, even if the taxpayer qualifies as a dealer in other securities. A taxpayer will not be treated as a dealer in securities based on sales to unrelated persons of receivables subject to the new provision unless the regulatory exception for receivables held for sale to customers applies.

The IRS Reform Act provision also applies to trade receivables arising from services performed by independent contractors, as well as employees. Thus, for example, if a taxpayer’s principal activity is selling non-financial services and some or all of such services are performed by independent contractors, no receivables that the taxpayer accepts for services can be marked-to-market under the new provision.

Pursuant to the authority granted by IRC Sec. 475(g)(1), the Secretary of the Treasury is authorized to issue regulations to prevent abuse of the new exception, including through independent contractor arrangements.

The provision provides that, to the extent provided in Treasury regulations, trade receivables that are held for sale to customers by the taxpayer or a related person may be treated as “securities” for purposes of the mark-to-market rules, and transactions in such receivables could result in a taxpayer being treated as a dealer in securities (IRC Sec. 475(c)(1)).

For trade receivables that are excepted from the statutory mark-to-market rules (IRC Sec. 475) under the new provision, mark-to-market or lower-of-cost-or-market will not be treated as methods of accounting that clearly reflect income under general tax principles (see IRC Sec. 446(b)).

The provision generally is effective for taxable years ending after July 22, 1998. Adjustments required under IRC Sec. 481 as a result of the change in method of accounting generally are required to be taken into account for federal purposes ratably over the four-year period beginning in the first taxable year for which the provision is in effect.

California Law

Current California law is in full conformity with federal law as it read on January 1, 1998, as it relates to the “mark to market” method of accounting.

This bill would conform California law to federal law as its relates to “mark to market” method of accounting for dealers. This bill would also require adjustments under IRC Sec. 481 as a result of the change in method of accounting to be taken into account for state purposes ratably over a three-year period beginning in 2002.

5. Exclusion of Minimum Required Distributions from AGI for Roth IRA Conversions

Under federal and California laws, uniform minimum distribution rules generally apply to all types of tax-favored retirement vehicles, including qualified retirement plans and annuities, individual retirement arrangements (IRAs) other than Roth IRAs, and tax-sheltered annuities (IRC Sec. 403(b)).

Under federal and California laws, distributions for IRAs must begin no later than April 1st of the calendar year following the calendar year in which the IRA owner attains age 70½. The IRS has issued extensive regulations for purposes of calculating minimum distributions. In general, minimum distributions are includible in gross income in the year of distribution. An excise tax equal to 50% of the required distribution applies to the extent a required distribution is not made.

Under federal and California laws, all or any part of amounts in a deductible or nondeductible IRA may be converted into a Roth IRA. Only taxpayers with modified adjusted gross income (AGI) of $100,000 or less for the year of the conversion are eligible to convert an IRA into a Roth IRA. In the case of a married taxpayer, AGI is the combined AGI of the couple.

The IRS Reform Act, for taxable years beginning after December 31, 2004, excludes minimum required distributions from IRAs for taxpayers 70½ years or older from the definition of modified AGI solely for purposes of determining eligibility to convert from an IRA to a Roth IRA. As under present law, the required minimum distribution would not be eligible for conversion and would be includible in gross income.

Current California law is in full conformity with federal law as it read on January 1, 1998, as it relates to Roth IRAs, except for the required minimum distribution exclusion.

This bill would conform California law with federal law as it relates to exclusion of required minimum distributions from modified AGI for purposes of Roth IRA conversions. The operative date of this provision is for taxable years beginning after December 31, 2004 (the federal operative date).

6. Farm Production Flexibility Contract Payments

Under federal and California laws, a taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless such amount is properly accounted for in a different period under the taxpayer's method of accounting. If a taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount regardless of whether the taxpayer actually receives the payment.

The Federal Agriculture Improvement and Reform Act of 1996 (the FAIR Act) provides for production flexibility contracts between certain eligible owners and producers and the Secretary of Agriculture. These contracts generally cover crop years from 1996 through 2002.

Annual payments are made under such contracts at specific times during the federal government's fiscal year. Section 112(d)(2) of the FAIR Act provides that one-half of each annual payment is to be made on either December 15th or January 15th of the fiscal year, at the option of the recipient. This option to receive the payment on December 15th potentially results in the constructive receipt (and thus potential inclusion in income) of one-half of the annual payment at that time, even if the option to receive the amount on January 15th is elected.

The remaining one-half of the annual payment must be made no later than September 30th of the fiscal year. The Emergency Farm Financial Relief Act of 1998 added Section 112(d)(3) to the FAIR Act, which provides that all payments for fiscal year 1999 are to be paid at such time or times during fiscal year 1999 as the recipient may specify. Thus, the one-half of the annual amount that would otherwise be required to be paid no later than September 30, 1999, can be specified for payment in calendar year 1998. This potentially results in the constructive receipt (and thus required inclusion in taxable income) of such amounts in calendar year 1998, regardless of whether the amounts actually are received or the right to their receipt is fixed.

Under the Tax and Trade Extension Act, the time a production flexibility contract payment under the FAIR Act is properly includible in income would be determined without regard to the options granted by Section 112(d)(2) (allowing receipt of one-half of the annual payment on either December 15th or January 15th of the fiscal year) or Section 112(d)(3)(allowing the acceleration of all payments for fiscal year 1999) of that Act. The provision is effective for production flexibility contract payments made under the FAIR Act in taxable years ending after December 31, 1995.

California Law

Current California law follows federal law in regards to the tax accounting concept of "constructive receipt." Therefore, the time a production flexibility contract payment received under the FAIR Act properly is includible in income would be determined by taking into account the options granted under the FAIR Act.

This bill would conform California law with federal law as it relates to farm production flexibility payments with the same effective date with respect to payments received in taxable and income years ending after December 31, 1995.

7. Treatment of Certain Deductible Liquidating Distributions of RICs/REITs

Regulated investment companies (RICs) and real estate investment trusts (REITs) are allowed a deduction for dividends paid to their shareholders. The deduction for dividends paid includes amounts distributed in liquidation that are properly chargeable to earnings and profits. In the case of a complete liquidation occurring within 24 months after the adoption of a plan of complete liquidation, the deduction includes any distribution made pursuant to the plan to the extent of earnings and profits. Rules that govern the receipt of dividends from RICs and REITs generally provide for including the amount of the dividend in the income of the shareholder receiving the dividend that was deducted by the RIC or REIT. Generally, any shareholder realizing gain from a liquidating distribution of a RIC or REIT includes the amount of gain in the shareholder's income.

However, in the case of a liquidating distribution to a corporation owning 80% of the stock of the distributing corporation, a separate rule generally provides that the distribution is tax-free to the parent corporation. The parent corporation succeeds to the tax attributes, including the adjusted basis of assets distributed. Under these rules, a liquidating RIC or REIT might be allowed a deduction for amounts paid to its parent corporation, without a corresponding inclusion in the income of the parent corporation, resulting in income not being subject to tax.

A RIC or REIT may designate a portion of a dividend as a capital gain dividend to the extent the RIC or REIT itself has a net capital gain. A RIC may designate a portion of the dividend paid to a corporate shareholder as eligible for the 70% dividends-received deduction to the extent the RIC itself received dividends from other corporations. If certain conditions are satisfied, a RIC also is permitted to pass through to its shareholders the tax-exempt character of the RIC's net income from tax-exempt obligations through the payment of "exempt interest dividends," though no deduction is allowed for such dividends.

The Tax and Trade Extension Act provides that any amount which a liquidating RIC or REIT may take as a deduction for dividends paid with respect to an otherwise tax-free liquidating distribution to an 80% corporate owner is includible in the income of the recipient corporation. The includible amount is treated as a dividend received from the RIC or REIT. The liquidating corporation may designate the amount distributed as a capital gain dividend or, in the case of a RIC, a dividend eligible for the 70% dividends received deduction or an exempt interest dividend, to the extent provided by the RIC or REIT provisions of the IRC.

The Tax and Trade Extension Act does not otherwise change the tax treatment of the distribution to the parent corporation or to the RIC or REIT. Thus, for example, the liquidating corporation will not recognize gain (if any) on the liquidating distribution and the recipient corporation will hold the assets at a carryover basis, even where the amount received is treated as a dividend. The provision is effective for distributions on or after May 22, 1998, regardless of when the plan of liquidation was adopted. No inference is intended regarding the treatment of such transactions under present law.

California Law

Current California law conforms to the federal treatment of RICs and REITs with certain modifications. California is conformed to the federal treatment of a liquidating distribution from a RIC or a REIT prior to the enactment of the Tax and Trade Extension Act. However, California has not conformed to the modification made by IRS Reform Act Section 6012(g) relating to "earnings and profits" ordinary distributions of REITs.

This bill would conform California law with federal law as it relates to liquidating distributions from RICs and REITs, effective for distributions made on or after January 1, 2000. This bill would not conform California law with federal law as it relates to “earnings and profits" ordinary distributions of REITs.

8. Tax Treatment of Cash Options for Qualified Prizes

Under federal and California laws, a taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless the item properly is accounted for in a different period under the taxpayer's method of accounting. If a taxpayer has an unrestricted right to demand payment of an amount, the taxpayer is in constructive receipt of that amount regardless of whether the taxpayer makes the demand and actually receives the payment. Under the principle of constructive receipt, the winner of a contest who is given the option of receiving either a lump-sum distribution or an annuity after winning the contest is required to include the value of the award in gross income, even if the annuity option is exercised.

Under the Tax and Trade Extension Act, the existence of a "qualified prize option" is disregarded in determining the taxable year for which any portion of a qualified prize is to be included in income. A qualified prize option is an option that entitles a person to receive a single cash payment in lieu of a qualified prize (or portion thereof), provided such option is exercisable not later than 60 days after the prize winner becomes entitled to the prize.

Thus, a qualified prize winner who may choose either cash or an annuity not later than 60 days after becoming entitled to the prize is not required to include amounts in gross income immediately if the annuity option is exercised. This provision applies with respect to any qualified prize to which a person first becomes entitled after October 21, 1998.

In addition, the Tax and Trade Extension Act also applies to any qualified prize to which a person became entitled on or before October 21, 1998, if the person has an option to receive a lump-sum cash payment only during some portion of the 18-month period beginning on July 1, 1999. This is intended to give previous prize winners a one-time option to alter previous payment arrangements.

Qualified prizes are prizes or awards from contests, lotteries, jackpots, games or similar arrangements that provide a series of payments over a period of at least 10 years, provided that the prize or award does not relate to any past services performed by the recipient and does not require the recipient to perform any substantial future service. Appearing in advertising relating to the prize or award is not (in and of itself) treated as substantial. The provision applies to individuals on the cash receipts and disbursements method of accounting. Income and deductions resulting from this provision retain their character as ordinary, not capital. In addition, the Secretary is to provide for the application of this provision in the case of a partnership or other pass-through entity consisting entirely of individuals on the cash receipts and disbursements method of accounting.

Any offer of a qualified prize option must include disclosure of the method used to compute the single cash payment, including the discount rate that makes equivalent the present values of the prize (or relevant portion thereof) and the single cash payment offered. Any offer of a qualified prize option must also clearly indicate that the prize winner is under no obligation to accept a single cash payment and may continue to receive the payments to which he or she is entitled under the terms of the qualified prize.

California Law

Current California law is generally conformed to federal law as of January 1, 1998, as it relates to the taxation of awards and prizes. California law specifically exempts California lottery winnings from taxable income for state purposes.

This bill would conform California law with federal law as it relates to the treatment of prizes other than California lottery winnings.

9. Payments Received Pursuant to the Ricky Ray Hemophilia Relief Fund Act

Generally, gross income does not include any damages received (whether by suit or agreement and whether as lump sum or as periodic payments) on account of a personal physical injury or physical sickness (IRC Sec. 104(a)(2)). If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) are treated as payments received on account of physical injury or physical sickness regardless of whether the recipient of the damages is the injured party.

The term "damages received whether by suit or agreement" is defined under Treasury regulations to mean an amount received (other than workmen's compensation) through prosecutions of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution. Under prior law, payments not meeting the requirements of IRC Sec. 104 were not excludable from income under that section.

The Ricky Ray Hemophilia Act treats payments to certain individuals with blood-clotting disorders who contracted the human immunodeficiency virus (HIV) due to contaminated blood products as damages received on account of personal physical injury or physical sickness described in IRC Sec. 104(a)(2). Thus, such payments made to individuals are excluded from gross income.

California Law

Current California law is in full conformity with federal law as it read on January 1, 1998, as it relates to the exclusion from income any damages received on account of a personal physical injury or physical sickness.

This bill would conform California law with federal treatment of payments received pursuant to the Ricky Ray Hemophilia Relief Fund Act.

10. Property Subject to a Liability Treated as Assumption of Liability

Prior federal and state laws provided that the transferor of property recognized no gain or loss if the property is exchanged solely for qualified stock in a controlled corporation (IRC Sec. 351). The assumption by the controlled corporation of a liability of the transferor (or the acquisition of property “subject to” a liability) generally did not cause the transferor to recognize gain.

However, under IRC Sec. 357(c), the transferor does recognize gain to the extent that the sum of the assumed liabilities, together with the liabilities to which the transferred property is subject, exceeds the transferor's basis in the transferred property. If the transferred property is “subject to” a liability, Treasury regulations indicate that the amount of the liability is included in the calculation regardless of whether the underlying liability is assumed by the controlled corporation. Similar rules apply to reorganizations described in IRC Sec. 368(a)(1)(D).

The gain recognition rule of IRC Sec. 357(c) is applied separately to each transferor in an IRC Sec. 351 exchange.

The basis of the property in the hands of the controlled corporation equals the transferor's basis in such property, increased by the amount of gain recognized by the transferor, including IRC Sec. 357(c) gain.

Under the Miscellaneous Trade and Technical Corrections Act of 1999, the distinction between the assumption of a liability and the acquisition of an asset subject to a liability generally is eliminated.

In general, a recourse liability (or any portion thereof) is treated as having been assumed if, as determined on the basis of all facts and circumstances, the transferee has agreed to, and is expected to satisfy the liability or portion thereof (regardless of whether the transferor has been relieved of the liability). Thus, where more than one person agrees to satisfy a liability or portion thereof, only one would be expected to satisfy such liability or portion thereof.

Also, a nonrecourse liability (or any portion thereof) is treated as having been assumed by the transferee of any asset that is subject to the liability. However, this amount is reduced in cases where an owner of other assets subject to the same nonrecourse liability agrees with the transferee to, and is expected to, satisfy the liability (up to the fair market value of the other assets, determined without regard to IRC Sec. 7701(g)).

In determining whether any person has agreed to and is expected to satisfy a liability, all facts and circumstances are to be considered. In any case where the transferee does agree to satisfy a liability, the transferee also will be expected to satisfy the liability in the absence of facts indicating the contrary.

In determining any increase to the basis of property transferred to the transferee as a result of gain recognized because of the assumption of liabilities under IRC Sec. 357, in no event will the increase cause the basis to exceed the fair market value of the property (determined without regard to IRC Sec. 7701(g)).

If gain is recognized to the transferor as the result of an assumption by a corporation of a nonrecourse liability that also is secured by any assets not transferred to the corporation, and if no person is subject to federal income tax on such gain, then for purposes of determining the basis of assets transferred, the amount of gain treated as recognized as the result of such assumption of liability shall be determined as if the liability assumed by the transferee equaled such transferee's ratable portion of the liability, based on the relative fair market values (determined without regard to IRC Sec. 7701(g)) of all assets subject to such nonrecourse liability.

In no event will the gain cause the resulting basis to exceed the fair market value of the property (determined without regard to IRC Sec. 7701(g)).

The Treasury Department has authority to prescribe such regulations as may be necessary to carry out the purposes of the provision. This authority includes the authority to specify adjustments in the treatment of any subsequent transactions involving the liability, including the treatment of payments actually made with respect to any liability as well as appropriate basis and other adjustments with respect to such payments. Where appropriate, the Treasury Department also may prescribe regulations which provide that the manner in which a liability is treated as assumed under the provision is applied elsewhere in the IRC.

California Law

Current state law conforms with federal law as it relates to the transfer of assets to a controlled corporation prior to the passage of the Miscellaneous Trade and Technical Corrections Act Of 1999.

This bill would conform state law to the Miscellaneous Trade and Technical Corrections Act of 1999 by eliminating the distinction between the assumption of a liability and the acquisition of an asset subject to a liability for transfers on or after January 1, 2002[

11. Extend Tentative Minimum Tax Relief for Individuals

Federal law provides for certain nonrefundable personal tax credits (i.e., the dependent care credit, the credit for the elderly and disabled, the adoption credit, the child tax credit, the credit for interest on certain home mortgages, the HOPE Scholarship and Lifetime Learning credits, and the D.C. homebuyer's credit). Except for taxable years beginning during 1998, these credits are allowed only to the extent that the individual's regular income tax liability exceeds the individual's tentative minimum tax (TMT), determined without regard to the minimum tax foreign tax credit.

For taxable years beginning during 1998, these credits are allowed to the extent of the full amount of the individual's regular tax (without regard to TMT).

The Ticket to Work and Work Incentives Improvement Act of 1999 extends to taxable years beginning in 1999 the provision that allows the personal nonrefundable credits to offset the individual's regular tax liability in full (as opposed to only the amount by which the regular tax exceeds TMT).

For taxable years beginning in 2000 and 2001, the personal nonrefundable credits may offset both the regular tax and the alternative minimum tax (AMT). The foreign tax credit will be allowed before the personal credits in computing the regular tax for these years. The refundable child credit will not be reduced by the amount of an individual's minimum tax in taxable years beginning in 1999, 2000, and 2001.

California Law

Current state law is generally in conformity with federal law as it relates to the computation of AMT and TMT as well as the limitation of credits to the excess of regular tax over TMT. The amounts included in the computation may differ due to other differences in the laws such as the threshold amounts and the California AMT rate of 7%.

Prior to AB 1637 (Stats. 1999, Ch. 930,), the only “personal” type credit allowed to reduce the regular tax amount below TMT was the renter’s credit.

Starting in the 1999 tax year, AB 1637 eliminated the TMT limitation on personal exemption credits by allowing the “exemption” credits to reduce regular tax below TMT.

“Exemption” credits are the personal, dependent, blind and senior credits only. California law still limits other “personal” type credits to the excess of regular tax over TMT.

Other “personal” type credits are the joint custody head of household, dependent parent, senior head of household and child adoption credits. The senior head of household and child adoption credits have AGI limitations. The interaction of the AGI limitations and the AMT threshold amounts reduce the number of taxpayers taking one of these two credits being affected by the TMT limitation.

Starting in the 2002 taxable year, this bill would eliminate the TMT limitation on the joint custody head of household, dependent parent, senior head of household and child adoption credits.

12. Extend Expensing of Environmental Remediation Expenditures

Under federal and state laws, taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred (IRC Sec. 198). The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. A “qualified contaminated site” generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate state environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called “brownfields”).

Targeted areas are defined as: (1) empowerment zones and enterprise communities as designated under present law; (2) sites announced before February, 1997, as being subject to one of the 76 Environmental Protection Agency (EPA) Brownfields Pilots; (3) any population census tract with a poverty rate of 20% or more; and (4) certain industrial and commercial areas that are adjacent to tracts described in (3) above. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 cannot qualify as targeted areas. Eligible expenditures are those paid or incurred before January 1, 2001.

The Ticket to Work and Work Incentives Improvement Act of 1999 extended the expiration date of December 31, 2000 for IRC Section 198 to include those expenditures paid or incurred before January 1, 2002. The Appropriations Act, 2001, extended the above mentioned treatment to expenditures incurred before January 1, 2004.

In addition, the Appropriations Act, 2001 eliminated the targeted area requirement, thereby expanding eligible sites to include any site containing (or potentially containing) a hazardous substance that is certified by the appropriate state environmental agency. However, expenditures undertaken at sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 would continue to not qualify as eligible expenditures.

California Law

California is in conformity with federal law as it relates to environmental remediation expenditures; however, as under prior federal law, the provision applies only to expenditures paid or incurred before January 1, 2001. In addition, an election to deduct remediation expenditures for federal purposes is applicable for California purposes. No separate election is allowed.

This bill would conform state law to the federal extension of the expiration date to include those expenditures paid or incurred on or after January 1, 2002 and before January 1, 2004.

13. Provide that Federal Production Payments Are Taxable in the Year Received

Under federal and state laws, a taxpayer generally is required to include an item in income no later than the time of its actual or constructive receipt, unless such amount properly is accounted for in a different period under the taxpayer's method of accounting. If a taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount regardless of whether the taxpayer makes the demand and actually receives the payment.

The Federal Agriculture Improvement and Reform Act of 1996 (the FAIR Act) provides for production flexibility contracts between certain eligible owners and producers and the Secretary of Agriculture. These contracts generally cover crop years from 1996 through 2002. Annual payments are made under such contracts at specific times during the federal government's fiscal year. Section 112(d)(2) of the FAIR Act provides that one-half of each annual payment is to be made on either December 15 or January 15 of the fiscal year, at the option of the recipient. The remaining one-half of the annual payment must be made no later than September 30 of the fiscal year. The Emergency Farm Financial Relief Act of 1998 added Section 112(d)(3) to the FAIR Act, which provides that all payments for fiscal year 1999 are to be paid at such time or times during fiscal year 1999 as the recipient may specify. Thus, the one-half of the annual amount that would otherwise be required to be paid no later than September 30, 1999, can be specified for payment in calendar year 1998.

These options potentially would have resulted in the constructive receipt (and thus inclusion in income) of the payments to which they relate at the time they could have been exercised, regardless of whether they were in fact exercised. However, Section 2012 of the Tax and Trade Relief Extension Act of 1998 provided that the time a production flexibility contract payment under the FAIR Act properly is includible in income is to be determined without regard to either option, effective for production flexibility contract payments made under the FAIR Act in taxable years ending after December 31, 1995.

The Ticket to Work and Work Incentives Improvement Act of 1999 provides that any unexercised option to accelerate the receipt of any payment under a production flexibility contract payable under the FAIR Act, as in effect on December 17, 1999, is disregarded in determining the taxable year in which such payment is properly included in gross income. Options to accelerate payments that are enacted in the future are covered by this rule, providing the payment to which they relate is mandated by the FAIR Act as in effect on December 17, 1999. The provision does not delay the inclusion of any amount in gross income beyond the taxable period in which the amount is received.

California Law

Current state law follows federal law as it read on January 1, 1998, in regards to the tax accounting concept of "constructive receipt." Therefore, the time a production flexibility contract payment received under the FAIR Act is properly includible in income would be determined by taking into account the options granted under the FAIR Act.

This bill would conform state law to the new federal rule, which provides that any unexercised option under the FAIR Act is disregarded in determining the taxable or income year in which that payment is properly included in gross income.

14. Clarify the Tax Treatment of Income and Losses from Derivatives

Under federal and state laws, capital gain treatment applies to gain on the sale or exchange of a capital asset.

Capital assets include property other than (1) stock in trade or other types of assets includible in inventory, (2) property used in a trade or business that is real property or property subject to depreciation, (3) accounts or notes receivable acquired in the ordinary course of a trade or business, (4) certain copyrights (or similar property), and (5) U.S. government publications. Gain or loss on such assets generally is treated as ordinary income or loss, rather than capital gain or loss. Certain other provisions also treat gains or losses as ordinary income or loss. For example, the gains or losses of securities dealers or certain electing commodities dealers or electing traders in securities or commodities that are subject to "mark-to-market" accounting are treated as ordinary income or loss (IRC Sec. 475).

Treasury regulations (which were finalized in 1994) require ordinary income or loss character treatment for most business hedges and provide timing rules requiring that gains or losses on hedging transactions be taken into account in a manner that matches the income or loss from the hedged item or items. The regulations apply to hedges that meet a standard of "risk reduction" with respect to ordinary property held (or to be held) or certain liabilities incurred (or to be incurred) by the taxpayer and that meet certain identification and other requirements (Treas. Reg. Sec. 1.1221-2).

Effective for any instrument held, acquired, or entered into, any transaction entered into, and supplies held or acquired on or after December 17, 1999, the Ticket to Work and Work Incentives Improvement Act of 1999 adds three categories to the list of assets the gain or loss on which is treated as ordinary (IRC Sec. 1221) income or loss.

The new categories are: (1) commodities derivative financial instruments held by commodities derivatives dealers; (2) hedging transactions; and (3) supplies of a type regularly consumed by the taxpayer in the ordinary course of a taxpayer's trade or business. In defining a hedging transaction, the provision generally codifies the approach taken by the Treasury regulations, but modifies the rules. The "risk reduction" standard of the regulations is broadened to "risk management" with respect to ordinary property held (or to be held) or certain liabilities incurred (or to be incurred).

Additionally, the Act provides that the definition of a hedging transaction includes a transaction entered into primarily to manage such other risks as the Secretary may prescribe in regulations.

California Law

Current state law conforms with federal law as it relates to taxation of income and losses on derivatives prior to the passage the Ticket to Work and Work Incentives Improvement Act of 1999. However, California's capital gain tax rate is the same as ordinary income tax rate.

This bill would conform state law to the changes made to federal law with respect to taxation of income and losses on derivatives effective for any instrument held, acquired, or entered into, any transaction entered into, and supplies held or acquired on or after January 1, 2002.

15. Expand Reporting of Cancellation of Indebtedness Income

Under federal and state laws, a taxpayer's gross income includes income from the discharge of indebtedness.

Federal law requires "applicable entities" to file information returns with the Internal Revenue Service (IRS) regarding any discharge of indebtedness of $600 or more. The information return must set forth the name, address, and taxpayer identification number of the person whose debt was discharged, the amount of debt discharged, the date on which the debt was discharged, and any other information that the IRS requires to be provided.

The information return must be filed in the manner and at the time specified by the IRS. The same information also must be provided to the person whose debt is discharged by January 31 of the year following the discharge.

"Applicable entities" include: (1) the Federal Deposit Insurance Corporation (FDIC), the Resolution Trust Corporation (RTC), the National Credit Union Administration, and successor or subunit of any of them; (2) any financial institution (as described in IRC Sec. 581 (relating to banks) or IRC Sec. 591(a) (relating to savings institutions)); (3) any credit union; (4) any corporation that is a direct or indirect subsidiary of an entity described in (2) or (3) which, by virtue of being affiliated with such entity, is subject to supervision and examination by a federal or state agency regulating such entities; and (5) an executive, judicial, or legislative agency (as defined in 31 U.S.C. Section 3701(a)(4)).

Failures to file correct information returns with the IRS or to furnish statements to taxpayers with respect to these discharges of indebtedness are subject to the same general penalty that is imposed with respect to failures to provide other types of information returns. Accordingly, the penalty for failure to furnish statements to taxpayers is generally $50 per failure, subject to a maximum of $100,000 for any calendar year. These penalties are not applicable if the failure is due to reasonable cause and not to willful neglect.

The Ticket to Work and Work Incentives Improvement Act of 1999 requires information reporting on indebtedness discharged by any organization for which a significant trade or business is the lending of money (such as finance companies and credit card companies regardless of whether affiliated with financial institutions).

California Law

Current state law conforms to the federal information reporting requirements for cancellation of indebtedness income prior to the passage of the Act by allowing the department to request a copy of the information return filed with the IRS.

This bill would conform to the expansion of the entities from which a copy of the information return filed with the IRS could be obtained by the department.

16. Limit Conversion of Character of Income from Constructive Ownership Transactions

Under federal law, the maximum individual income tax rate on ordinary income and short-term capital gain is 39.6%, while the maximum individual income tax rate on long-term capital gain generally is 20%. Although state law conforms to the definitions, rules, and holding periods for ordinary income, short-term capital gain, and long-term capital gain, there is no difference in the tax rate applicable to these categories of income.

Under federal and state laws, long-term capital gain means gain from the sale or exchange of a capital asset held more than one year. For this purpose, gain from the termination of a right with respect to property which would be a capital asset in the hands of the taxpayer is treated as capital gain.

A pass-through entity (such as a partnership) generally is not subject to federal or state income tax. Rather, each owner includes its share of a pass-through entity's income, gain, loss, deduction or credit in its taxable income. Generally, the character of the item is determined at the entity level and flows through to the owners. Thus, for example, the treatment of an item of income by a partnership as ordinary income, short-term capital gain, or long-term capital gain retains its character when reported by each of the partners.

Investors may enter into forward contracts, notional principal contracts, and other similar arrangements with respect to property that provides the investor with the same or similar economic benefits as owning the property directly but with potentially different tax consequences (to the character and timing of any gain).

The Ticket to Work and Work Incentives Improvement Act of 1999 limited the amount of long-term capital gain a taxpayer could recognize from certain derivative contracts (“constructive ownership transactions”) with respect to certain financial assets.

The amount of long-term capital gain is limited to the amount of such gain the taxpayer would have recognized if the taxpayer held the financial asset directly during the term of the derivative contract. Any gain in excess of this amount is treated as ordinary income. An interest charge is imposed on the amount of gain that is treated as ordinary income. The provision does not alter the tax treatment of the long-term capital gain that is not treated as ordinary income.

A taxpayer is treated as having entered into a constructive ownership transaction if the taxpayer (1) holds a long position under a notional principal contract with respect to the financial asset, (2) enters into a forward contract to acquire the financial asset, (3) is the holder of a call option, and the grantor of a put option, with respect to a financial asset, and the options have substantially equal strike prices and substantially contemporaneous maturity dates, or (4) to the extent provided in regulations, enters into one or more transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described. Treasury regulations, when issued, are expected to provide specific standards for determining when other types of financial transactions, like those specified in the provision, have substantially the same effect of replicating the economic benefits of direct ownership of a financial asset without a significant change in the risk-reward profile with respect to the underlying transaction. It is not expected that leverage in a constructive ownership transaction would change the risk-reward profile with respect to the underlying transaction.

A “financial asset” is defined as (1) any equity interest in a pass-through entity, and (2) to the extent provided in regulations, any debt instrument and any stock in a corporation that is not a pass-through entity. A “pass-through entity” refers to:

(1) a regulated investment company (RIC),
(2) a real estate investment trust (REIT),
(3) a real estate mortgage investment conduit (REMIC),
(4) an S corporation,
(5) a partnership,
(6) a trust,
(7) a common trust fund,
(8) a passive foreign investment company (PFC) which includes an investment company that is also a controlled foreign corporation,
(9) a foreign personal holding company, and
(10) a foreign investment company.

The amount of recharacterized gain is calculated as the excess of the amount of long-term capital gain the taxpayer would have had absent this provision over the “net underlying long-term capital gain” attributable to the financial asset.

The net underlying long-term capital gain is the amount of net capital gain the taxpayer would have realized if it had acquired the financial asset for its fair market value on the date the constructive ownership transaction was opened and sold the financial asset on the date the transaction was closed (only taking into account gains and losses that would have resulted from a deemed ownership of the financial asset). A taxpayer must establish the amount of the net underlying long-term capital gain with clear and convincing evidence; otherwise, the amount is deemed to be zero.

To the extent that the economic positions of the taxpayer and the counter party do not equally offset each other, the amount of the net underlying long-term capital gain may be difficult to establish. The long-term capital gains rate on the net underlying long-term capital gain is determined by reference to the individual capital gains rates.

> Example 1: On January 1, 2000, Taxpayer enters into a three-year notional principal contract (a constructive ownership transaction) with a securities dealer whereby, on the settlement date, the dealer agrees to pay Taxpayer the amount of any increase in the notional value of an interest in an investment partnership (the financial asset). After three years, the value of the notional principal contract increased by $200,000, of which $150,000 is attributable to ordinary income and net short-term capital gain ($50,000 is attributable to net long-term capital gains). The amount of the net underlying long-term capital gains is $50,000, and the amount of gain that is recharacterized as ordinary income is $150,000 (the excess of $200,000 of long-term gain over the $50,000 of net underlying long-term capital gain).

An interest charge is imposed on the underpayment of tax for each year that the constructive ownership transaction was open. The interest charge is the amount of interest that would be imposed had the recharacterized gain been included in the taxpayer's gross income during the term of the constructive ownership transaction. The recharacterized gain is treated as having accrued such that the gain in each successive year is equal to the gain in the prior year increased by a constant growth rate during the term of the constructive ownership transaction.

> Example 2: Same facts as in example 1, and assume the applicable federal rate on December 31, 2002, is 6%. For purposes of calculating the interest charge, Taxpayer must allocate the $150,000 of recharacterized ordinary income to the three year-term of the constructive ownership transaction as follows: $47,116.47 is allocated to year 2000, $49,943.46 is allocated to year 2001, and $52,940.07 is allocated to year 2002.

A taxpayer is treated as holding a long position under a notional principal contract with respect to a financial asset if the person (1) has the right to be paid (or receive credit for) all or substantially all of the investment yield (including appreciation) on the financial asset for a specified period, and (2) is obligated to reimburse (or provide credit) for all or substantially all of any decline in the value of the financial asset. A forward contract is a contract to acquire in the future (or provide or receive credit for the future value of) any financial asset.

If the constructive ownership transaction is closed by reason of taking delivery of the underlying financial asset, the taxpayer is treated as having sold the contract, option, or other position that is part of the transaction for its fair market value on the closing date. However, the amount of gain that is recognized as a result of having taken delivery is limited to the amount of gain that is treated as ordinary income by reason of this provision (with appropriate basis adjustments for such gain).
The provision does not apply to any constructive ownership transaction if all of the positions that are part of the transaction are marked to market under the IRC or regulations. The Treasury Department is authorized to prescribe regulations as necessary to carry out the purposes of the provision, including to (1) permit taxpayers to mark to market constructive ownership transactions in lieu of the provision, and (2) exclude certain forward contracts that do not convey substantially all of the economic return with respect to a financial asset.

For federal purposes the provision applies to transactions entered into on or after July 12, 1999. For this purpose, it is expected that a contract, option or any other arrangement that is entered into or exercised on or after July 12, 1999, which extends or otherwise modifies the terms of a transaction entered into prior to such date will be treated as a transaction entered into on or after July 12, 1999, unless a party to the transaction other than the taxpayer has, as of July 12, 1999, the exclusive right to extend the terms of the transaction, and the length of such extension does not exceed the first business day following a period of five years from the original termination date under the transaction. No inference is intended as to the proper treatment of a constructive ownership transaction entered into prior to the effective date of this provision.

California Law

Current state law is generally in conformity with federal law as it relates to the computation of capital gain verses ordinary income. California, however, does not have different tax rates for capital gain and ordinary income.

This bill conforms to the new federal rules regarding constructive ownership transactions entered into on or after January 1, 2002.

17. Treatment of Excess Pension Assets Used for Retiree Health Benefits

Under federal and state laws, defined benefit pension plan assets generally may not revert to an employer prior to the termination of the plan and the satisfaction of all plan liabilities. A reversion prior to plan termination may constitute a prohibited transaction and may result in disqualification of the plan. Certain limitations and procedural requirements apply to a reversion upon plan termination. Under federal and state laws, any assets that revert to the employer upon plan termination are includible in the gross income of the employer.

Under federal law, such assets are subject to an excise tax. Under federal and state law upon plan termination, the accrued benefits of all plan participants are required to be 100% vested.

Under federal and state laws, a pension plan may provide medical benefits to retired employees through an IRC Sec. 401(h) account that is a part of such plan. A qualified transfer of excess assets of a defined benefit pension plan (other than a multi-employer plan) into an IRC Sec. 401(h) account that is a part of such plan does not result in plan disqualification and is not treated as a reversion to the employer or a prohibited transaction. Therefore, the transferred assets are not includible in the gross income of the employer and are not subject to the excise tax on reversions.

Qualified transfers are subject to amount and frequency limitations, use requirements, deduction limitations, vesting requirements, and minimum benefit requirements.

Excess assets transferred in a qualified transfer may not exceed the amount reasonably estimated to be the amount that the employer will pay out of such account during the taxable year of the transfer for qualified current retiree health liabilities. No more than one qualified transfer with respect to any plan may occur in any taxable year.

The transferred assets (and any income thereon) must be used to pay qualified current retiree health liabilities (either directly or through reimbursement) for the taxable year of the transfer. Transferred amounts generally must benefit all pension plan participants, other than key employees, who are entitled upon retirement to receive retiree medical benefits through the IRC Sec. 401(h) account. Retiree health benefits of key employees may not be paid (directly or indirectly) out of transferred assets. Amounts not used to pay qualified current retiree health liabilities for the taxable year of the transfer are to be returned at the end of the taxable year to the general assets of the plan. These amounts are not includible in the gross income of the employer, but are treated as an employer reversion and are subject to a 20% federal excise tax.

No deduction is allowed for (1) a qualified transfer of excess pension assets into an IRC Sec. 401(h) account, (2) the payment of qualified current retiree health liabilities out of transferred assets (and any income thereon) or (3) a return of amounts not used to pay qualified current retiree health liabilities to the general assets of the pension plan.

In order for the transfer to be qualified, accrued retirement benefits under the pension plan generally must be 100% vested as if the plan terminated immediately before the transfer.

The minimum benefit requirement requires each group health plan under which applicable health benefits are provided to provide substantially the same level of applicable health benefits for the taxable year of the transfer and the following four taxable years. The level of benefits that must be maintained is based on benefits provided in the year immediately preceding the taxable year of the transfer. Applicable health benefits are health benefits or coverage that are provided to (1) retirees who, immediately before the transfer, are entitled to receive such benefits upon retirement and who are entitled to pension benefits under the plan and (2) the spouses and dependents of such retirees.

The provision permitting a qualified transfer of excess pension assets to pay qualified current retiree health liabilities expires for taxable years beginning after December 31, 2000.

The Ticket to Work and Work Incentives Improvement Act of 1999 extends the present-law provision permitting qualified transfers of excess defined benefit pension plan assets to provide retiree health benefits under an IRC Sec. 401(h) account through December 31, 2005.

In addition, the present law minimum benefit requirement is replaced by the minimum cost requirement that applied to qualified transfers before December 9, 1994, to IRC Sec. 401(h) accounts.

Therefore, each group health plan or arrangement under which applicable health benefits are provided is required to provide a minimum dollar level of retiree health expenditures for the taxable year of the transfer and the following four taxable years. The minimum dollar level is the higher of the applicable employer costs for each of the two taxable years immediately preceding the taxable year of the transfer. The applicable employer cost for a taxable year is determined by dividing the employer's qualified current retiree health liabilities by the number of individuals to whom coverage for applicable health benefits was provided during the taxable year.

The Secretary of the Treasury is directed to prescribe such regulations as may be necessary to prevent an employer who significantly reduces retiree health coverage during the cost maintenance period from being treated as satisfying the minimum cost requirement. In addition, the provision contains a transition rule regarding the minimum cost requirement.

California Law

Current state law conforms to the federal law provisions relating to qualified transfers of excess defined benefit pension plans as it read on January 1, 1998. However, California does not impose the excise tax on assets that revert to the employer upon termination of the plan.

This bill would conform to the provision permitting qualified transfers of excess defined benefit pension plan assets to provide retiree health benefits under an IRC Sec. 401(h) account through December 31, 2005. In addition, this bill would conform to the provision replacing the present law minimum benefit requirement with the new federal minimum cost requirement.

18. Modification of the Installment Method Pledge Rules

An accrual method taxpayer is generally required to recognize income when all the events have occurred that fix the right to the receipt of the income and the amount of the income can be determined with reasonable accuracy. The installment method of accounting provides an exception to this general principle of income recognition by allowing a taxpayer to defer the recognition of income from the disposition of certain property until payment is received. Sales to customers in the ordinary course of business are not eligible for the installment method, except for sales of property that is used or produced in the trade or business of farming and sales of timeshares and residential lots if an election to pay interest under section 453(l)(2)(B) is made.

A pledge rule provides that if an installment obligation is pledged as security for any indebtedness, the net proceeds of such indebtedness are treated as a payment on the obligation, triggering the recognition of income. Actual payments received on the installment obligation subsequent to the receipt of the loan proceeds are not taken into account until such subsequent payments exceed the loan proceeds that were treated as payments. The pledge rule does not apply to sales of property used or produced in the trade or business of farming, to sales of timeshares and residential lots where the taxpayer elects to pay interest under section 453(l)(2)(B), or to dispositions where the sales price does not exceed $150,000.

An additional rule requires the payment of interest on the deferred tax that is attributable to most large installment sales.

The Ticket to Work Act modifies the pledge rule to provide that entering into any arrangement that gives the taxpayer the right to satisfy an obligation with an installment note will be treated in the same manner as the direct pledge of the installment note. For example, a taxpayer disposes of property for an installment note. The disposition is properly reported using the installment method. The taxpayer only recognizes gain as it receives the deferred payment.

However, were the taxpayer to pledge the installment note as security for a loan, it would be required to treat the proceeds of such loan as a payment on the installment note and recognize the appropriate amount of gain. Under the provision, the taxpayer would also be required to treat the proceeds of a loan as payment on the installment note to the extent the taxpayer had the right to “put” or repay the loan by transferring the installment note to the taxpayer's creditor. Other arrangements that have a similar effect would be treated in the same manner.

The modification of the pledge rule applies only to installment sales where the pledge rule of present law applies. Accordingly, the provision does not apply to (1) installment method sales made by a dealer in timeshares and residential lots where the taxpayer elects to pay interest under section 453(l)(2)(B), (2) sales of property used or produced in the trade or business of farming, or (3) dispositions where the sales price does not exceed $150,000, since such sales are not subject to the pledge rule under present law.

The Installment Tax Correction Act of 2000 [which hasn’t been mentioned previously] repealed the prohibition on the use of the installment method of accounting for dispositions of property that would otherwise be required to be reported using the accrual method of accounting. That Act left unchanged the 1999 modification to the pledge rule for federal purposes.

California Law

California is in conformity with federal law prior to the passage of the Ticket to Work Act and the Installment Tax Correction Act as it relates to installment sales.

This bill would conform to the changes made to the pledge rules the Ticket to Work Act.

19. Denial of Charitable Contrib. Deduct. for Transfers Assoc. w/ Split-Dollar Insurance Arrangement

Under current federal and state laws, in computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct charitable contributions paid during the taxable year. The amount of the deduction allowable for a taxable year with respect to any charitable contribution depends on the type of property contributed, the type of organization to which the property is contributed, and the income of the taxpayer. A charitable contribution is defined to mean a contribution or gift to or for the use of a charitable organization or certain other entities. The term “contribution or gift” is not defined by statute, but generally is interpreted to mean a voluntary transfer of money or other property without receipt of adequate consideration and with donative intent.

If a taxpayer receives or expects to receive a “quid pro quo” in exchange for a transfer to charity, the taxpayer may be able to deduct the excess of the amount transferred over the fair market value of any benefit received in return, provided the excess payment is made with the intention of making a gift.

In general, no charitable contribution deduction is allowed for a transfer to charity of less than the taxpayer's entire interest (i.e., a partial interest) in any property. In addition, no deduction is allowed for any contribution of $250 or more unless the taxpayer obtains a contemporaneous written acknowledgment from the donee organization that includes a description and good faith estimate of the value of any goods or services provided by the donee organization to the taxpayer in consideration, in whole or in part, for the taxpayer's contribution (i.e., the “quid pro quo”).

Deduction Denial

The Ticket to Work and Work Incentives Improvement Act Of 1999 restates present law to provide that no charitable contribution deduction is allowed for purposes of federal tax, for a transfer to or for the use of an organization described in IRC Sec. 170(c), if in connection with the transfer (1) the organization directly or indirectly pays, or has previously paid, any premium on any “personal benefit contract” with respect to the transferor, or (2) there is an understanding or expectation that any person will directly or indirectly pay any premium on any “personal benefit contract” with respect to the transferor. It is intended that an organization be considered as indirectly paying premiums if, for example, another person pays premiums on its behalf.

A personal benefit contract with respect to the transferor is any life insurance, annuity, or endowment contract, if any direct or indirect beneficiary under the contract is the transferor, any member of the transferor's family, or any other person (other than an IRC Sec. 170(c) organization) designated by the transferor.

For example, such a beneficiary would include a trust having a direct or indirect beneficiary who is the transferor or any member of the transferor's family, and would include an entity that is controlled by the transferor or any member of the transferor's family. It is intended that a beneficiary under the contract include any beneficiary under any side agreement relating to the contract. If a transferor contributes a life insurance contract to an I.R.C. Section 170(c) organization and designates one or more IRC Sec. 170(c) organizations as the sole beneficiaries under the contract, generally, it is not intended that the deduction denial rule under the provision apply. If, however, there is an outstanding loan under the contract upon the transfer of the contract, then the transferor is considered as a beneficiary. The fact that a contract also has other direct or indirect beneficiaries (persons who are not the transferor or a family member, or designated by the transferor) does not prevent it from being a personal benefit contract. The provision is not intended to affect situations in which an organization pays premiums under a legitimate fringe benefit plan for employees.

It is intended that a person be considered as an indirect beneficiary under a contract if, for example, the person receives or will receive any economic benefit as a result of amounts paid under or with respect to the contract. For this purpose, as described below, an indirect beneficiary is not intended to include a person that benefits exclusively under a bona fide charitable gift annuity (within the meaning of IRC Sec. 501(m)).

In the case of a charitable gift annuity, if the charitable organization purchases an annuity contract issued by an insurance company to fund its obligation to pay the charitable gift annuity, a person receiving payments under the charitable gift annuity is not treated as an indirect beneficiary, provided certain requirements are met. The requirements are that (1) the charitable organization possess all of the incidents of ownership (within the meaning of Treas. Reg. Section 20.2042 1(c)) under the annuity contract purchased by the charitable organization; (2) the charitable organization be entitled to all the payments under the contract; and (3) the timing and amount of payments under the contract be substantially the same as the timing and amount of payments to each person under the organization's obligation under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization).

Under the provision, an individual's family consists of the individual's grandparents, the grandparents of the individual's spouse, the lineal descendants of such grandparents, and any spouse of such a lineal descendant.

In the case of a charitable gift annuity obligation that is issued under the laws of a state that requires, in order for the charitable gift annuity to be exempt from insurance regulation by that state, that each beneficiary under the charitable gift annuity be named as a beneficiary under an annuity contract issued by an insurance company authorized to transact business in that state, then the foregoing requirements (1) and (2) are treated as if they are met, provided that certain additional requirements are met. The additional requirements are that the state law requirement was in effect on February 8, 1999, each beneficiary under the charitable gift annuity is a bona fide resident of the state at the time the charitable gift annuity was issued, the only persons entitled to payments under the annuity contract issued by the insurance company are persons entitled to payments under the charitable gift annuity when it was issued, and the timing and amount of payments under the annuity contract to each person are substantially the same as the timing and amount of payments to the person under the charitable gift annuity (as in effect at the time of the transfer to the charitable organization).

In the case of a charitable remainder annuity trust or charitable remainder unitrust that holds a life insurance, endowment or annuity contract issued by an insurance company, a person is not treated as an indirect beneficiary under the contract held by the trust, solely by reason of being a recipient of an annuity or unitrust amount paid by the trust, provided that the trust possesses all of the incidents of ownership under the contract and is entitled to all the payments under such contract. No inference is intended as to the applicability of other provisions of the IRC with respect to the acquisition by the trust of a life insurance, endowment or annuity contract, or the appropriateness of such an investment by a charitable remainder trust.

Nothing in the provision is intended to suggest that a life insurance, endowment, or annuity contract would be a personal benefit contract, solely because an individual who is a recipient of an annuity or unitrust amount paid by a charitable remainder annuity trust or charitable remainder unitrust uses such a payment to purchase a life insurance, endowment or annuity contract, and a beneficiary under the contract is the recipient, a member of his or her family, or another person he or she designates.

The federal deduction denial provision applies to transfers after February 8, 1999.

California Law

Current state law conforms to the federal law as it relates to charitable contribution deduction of split-dollar insurance prior to the passage the Ticket to Work and Work Incentives Improvement Act of 1999.

This bill conforms to the deduction denial provision with respect to transfers on or after January 1, 2002.

20. Distributions by a Partnership to a Corporate Partner of Stock in Another Corporation

Current federal and state laws generally provide that no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation in which it holds 80% of the stock (by vote and value) (IRC Sec. 332). The basis of property received by a corporate distributee in the distribution in complete liquidation of the 80% owned subsidiary is a carryover basis, i.e., the same as the basis in the hands of the subsidiary (provided no gain or loss is recognized by the liquidating corporation with respect to the distributed property) (IRC Sec. 334(b)).

Current federal and state laws provide two different rules for determining a partner's basis in distributed property, depending on whether or not the distribution is in liquidation of the partner's interest in the partnership.

Generally, a substituted basis rule applies to property distributed to a partner in liquidation. Thus, the basis of property distributed in liquidation of a partner's interest is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction) (IRC Sec. 732(b)).

By contrast, generally, a carryover basis rule applies to property distributed to a partner other than in liquidation of its partnership interest, subject to a cap (IRC Sec. 732(a)). Thus, in a non-liquidating distribution, the distributee partner's basis in the property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction). In a non-liquidating distribution, the partner's basis in its partnership interest is reduced by the amount of the basis to the distributee partner of the property distributed and is reduced by the amount of any money distributed (IRC Sec. 733).

If corporate stock is distributed by a partnership to a corporate partner with a low basis in its partnership interest, the basis of the stock is reduced in the hands of the partner so that the stock basis equals the distributee partner's adjusted basis in its partnership interest. No comparable reduction is made in the basis of the corporation's assets, however. The effect of reducing the stock basis can be negated by a subsequent liquidation of the corporation under IRC Sec. 332.

In General

The Ticket to Work and Work Incentives Improvement Act of 1999 provides for a basis reduction to assets of a corporation, if stock in that corporation is distributed by a partnership to a corporate partner. The reduction applies if, after the distribution, the corporate partner controls the distributed corporation.

1. Amount of the Basis Reduction

Under this provision, the amount of the reduction in basis of property of the distributed corporation generally equals the amount of the excess of (1) the partnership's adjusted basis in the stock of the distributed corporation immediately before the distribution, over (2) the corporate partner's basis in that stock immediately after the distribution.

The provision limits the amount of the basis reduction in two respects. First, the amount of the basis reduction may not exceed the amount by which (1) the sum of the aggregate adjusted bases of the property and the amount of money of the distributed corporation exceeds (2) the corporate partner's adjusted basis in the stock of the distributed corporation.

> For example, if the distributed corporation has cash of $300 and other property with a basis of $600 and the corporate partner's basis in the stock of the distributed corporation is $400, then the amount of the basis reduction could not exceed $500 (i.e., ($300+$600)-$400 = $500).

Second, the amount of the basis reduction may not exceed the adjusted basis of the property of the distributed corporation. Thus, the basis of property (other than money) of the distributed corporation could not be reduced below zero under the provision, even though the total amount of the basis reduction would otherwise be greater.

This provision provides that the corporate partner recognizes long-term capital gain to the extent the amount of the basis reduction exceeds the basis of the property (other than money) of the distributed corporation. In addition, the corporate partner's adjusted basis in the stock of the distribution is increased in the same amount.

> For example, if the amount of the basis reduction were $400, and the distributed corporation has money of $200 and other property with an adjusted basis of $300, then the corporate partner would recognize a $100 capital gain under the provision. The corporate partner's basis in the stock of the distributed corporation is also increased by $100 in this example, under the provision.

The basis reduction is allocated among assets of the controlled corporation in accordance with the rules provided under IRC Sec. 732(c).

2. Partnership Distributions Resulting in Control

The basis reduction generally applies with respect to a partnership distribution of stock if the corporate partner controls the distributed corporation immediately after the distribution or at any time thereafter. For this purpose, the term control means ownership of stock meeting the requirements of IRC Sec. 1504(a)(2) (generally, an 80% vote and value requirement).

This provision applies to reduce the basis of any property held by the distributed corporation immediately after the distribution, or, if the corporate partner does not control the distributed corporation at that time, then at the time the corporate partner first has such control. The provision does not apply to any distribution if the corporate partner does not have control of the distributed corporation immediately after the distribution and establishes that the distribution was not part of a plan or arrangement to acquire control.

For purposes of the provision, if a corporation acquires (other than in a distribution from a partnership) stock the basis of which is determined (by reason of being distributed from a partnership) in whole or in part by reference to IRC Sec. 732(a)(2) or (b), then the corporation is treated as receiving a distribution of stock from a partnership.

> For example, if a partnership distributes property other than stock (such as real estate) to a corporate partner, and that corporate partner contributes the real estate to another corporation in an IRC Sec. 351 transaction, then the stock received in the IRC Sec. 351 transaction is not treated as distributed by a partnership, and the basis reduction under this provision does not apply.
>
> As another example, if a partnership distributes stock to two corporate partners, neither of which have control of the distributed corporation, and the two corporate partners merge and the survivor obtains control of the distributed corporation, the stock of the distributed corporation that is acquired as a result of the merger is treated as received in a partnership distribution; the basis reduction rule of the provision applies.

In the case of tiered corporations, a special rule provides that if the property held by a distributed corporation is stock in a corporation that the distributed corporation controls, then the provision is applied to reduce the basis of the property of that controlled corporation. The provision is also reapplied to any property of any controlled corporation that is stock in a corporation that it controls. Thus, for example, if stock of a controlled corporation is distributed to a corporate partner, and the controlled corporation has a subsidiary, the amount of the basis reduction allocable to stock of the subsidiary is applied again to reduce the basis of the assets of the subsidiary, under the special rule.

This provision also provides for regulations, including regulations to avoid double counting and to prevent the abuse of the purposes of the provision. It is intended that regulations prevent the avoidance of the purposes of the provision through the use of tiered partnerships.

This provision is effective generally for distributions made after July 14, 1999. However, in the case of a corporation that is a partner in a partnership as of July 14, 1999, the provision is effective for any distribution made (or treated as made) to that partner from that partnership after June 30, 2001.

In the case of any such distribution after the date of enactment and before July 1, 2001, the rule of the preceding sentence does not apply unless that partner makes an election to have the rule apply to the distribution on the partner's return of federal income tax for the taxable year in which the distribution occurs.

No inference is intended that distributions that are not subject to the provision achieve a particular tax result under present law, and no inference is intended that enactment of the provision limits the application of tax rules or principles under present or prior law.

California Law

Current state law conforms to the federal law as it relates to partnership distributions of corporate stock prior to the passage of the Ticket to Work and Work Incentives Improvement Act of 1999.

This bill would conform to the new federal rules for transactions after January 1, 2002, and make the federal treatment elected by the taxpayer binding for state purposes.

21 Increase the Low-Income Housing Tax Credit Cap and Make Other Modifications

The low-income housing tax credit may be claimed over a 10-year period for the cost of rental housing occupied by tenants having incomes below specified levels. The credit percentage for newly constructed or substantially rehabilitated housing that is not federally-subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments have a present value of 70% of the total qualified expenditures. The credit percentage for new substantially rehabilitated housing that is federally-subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30% qualified expenditures.

Credit Cap

The aggregate credit authority provided annually to each state is $1.25 per resident, except in the case of projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit and certain carry-over amounts.

Expenditure Test

Generally, the building must be placed in service in the year in which it receives an allocation to qualify for the credit. An exception is provided in the case where the taxpayer has expended an amount equal to 10 percent or more of the taxpayer’s reasonably expected basis in the building by the end of the calendar year in which the allocation is received and certain other requirements are met.

Basis of Building Eligible for the Credit

Buildings receiving assistance under the HOME investment partnerships act (“HOME”) are not eligible for the enhanced credit for buildings located in high cost areas (i.e., qualified census tracts and difficult development areas). Under the enhanced credit, the 70 percent and 30 percent credit are increased to a 91 percent and 39 percent credit, respectively.

Eligible basis is generally limited to the portion of the building used by qualified low-income tenants for residential living and some common areas.

State Allocation Plans

Each state must develop a plan for allocating credits and such plan must include certain allocation criteria including:

(1) project location;
(2) housing needs characteristics;
(3) project characteristics;
(4) sponsor characteristics;
(5) participation of local tax-exempts;
(6) tenant populations with special needs; and
(7) public housing waiting lists.

The state allocation plan must also give preference to housing projects (1) that serve the lowest income tenants, and (2) that are obligated to serve qualified tenants for the longest periods.

Credit Administration

There are no explicit requirements that housing credit agencies perform a comprehensive market study of the housing needs of the low-income individuals in the area to be served by the project, nor that such agency conduct site visits to monitor for compliance with habitability standards.

Stacking Rule

Authority to allocate credits remains at the state (as opposed to local) government level, unless state law provides otherwise. Generally, credits may be allocated only from volume authority arising during the calendar year in which the building is placed in service, except in the case of:

(1) credits claimed on additions to qualified basis;
(2) credits allocated in a later year pursuant to an earlier binding commitment made no later than the year in which the building is placed in service; and
(3) carryover allocations.

Each state annually receives low-income housing credit authority equal to $1.25 per state resident for allocation to qualified low-income projects. In addition to this $1.25 per resident amount, each state's "housing credit ceiling" includes the following amounts:

(1) the unused state housing credit ceiling (if any) of such state for the preceding calendar year;
(2) the amount of the state housing credit ceiling (if any) returned in the calendar year; and
(3) the amount of the national pool (if any) allocated to such state by the Treasury Department.

The national pool consists of states' unused housing credit carryovers. For each state, the unused housing credit carryover for a calendar year consists of the excess (if any) of the unused state housing credit ceiling for such year over the excess (if any) of the aggregate housing credit dollar amount allocated for such year over the sum of $1.25 per resident and the credit returns for such year. The amounts in the national pool are allocated only to a state that allocated its entire housing credit ceiling for the preceding calendar year, and requested a share in the national pool not later than May 1 of the calendar year. The national pool allocation to qualified states is made on a pro rata basis equivalent to the fraction that a state's population enjoys relative to the total population of all qualified states for that year.

The stacking rule provides that a state is treated as using its annual allocation of credit authority ($1.25 per state resident) and any returns during the calendar year followed by any unused credits carried forward from the preceding year's credit ceiling and finally any applicable allocations from the national pool.

The Appropriations Act, 2001, makes the following changes in the low-income housing credit:

<u>Credit cap</u> -- Increases the per-capita low-income housing credit cap from $1.25 per capita to $1.50 per capita in calendar year 2001 and to $1.75 per capita in calendar year 2002. Beginning in calendar year 2003, the per-capita portion of the credit cap will be adjusted annually for inflation. For small states, a minimum annual cap of $2 million is provided for calendar years 2001 and 2002. Beginning in calendar year 2003, the small state minimum is adjusted for inflation.

<u>Expenditure test</u> -- Allows a building which receives an allocation in the second half of a calendar year to qualify under the 10 percent test if the taxpayer expends an amount equal to 10 percent or more of the taxpayer's reasonably expected basis in the building within six months of receiving the allocation, regardless of whether the 10 percent test is met by the end of the calendar year.

<u>Basis of building eligible for the credit</u> – The Appropriations Act, 2001 makes three changes to the basis rules of the credit. First, the definition of qualified census tracts for purposes of the enhanced credit is expanded to include any census tracts with a poverty rate of 25% or more. Second, the Appropriations Act, 2001 extends the credit to a portion of the building used as a community service facility not in excess of 10% of the total eligible basis in the building. A community service facility is defined as any facility designed to serve primarily individuals whose income is 60% or less of area median income. Third, the Appropriations Act, 2001 provides that assistance received under the Native American Housing Assistance and Self-Determination Act of 1996 is not taken into account in determining whether a building is federally subsidized for purposes of the credit. This allows such buildings to qualify for something other than the 30 percent credit generally applicable to federally subsidized buildings.

State allocation plans -- Strikes the plan criteria relating to participation of local tax-exempts, replacing it with two other criteria: (1) tenant populations of individuals with children, and (2) projects intended for eventual tenant ownership. It also provides that the present-law criteria relating to sponsor characteristics include whether the project involves the use of existing housing as part of a community revitalization plan. The Appropriations Act, 2001 adds a third category of housing projects to the preferential list, for projects located in qualified census tracts that contribute to a concerted community revitalization plan.

Credit administration --Requires a comprehensive market study of the housing needs of the low-income individuals in the area to be served by the project and a written explanation available to the general public for any allocation not made in accordance with the established priorities and selection criteria of the housing credit agency. They also require site inspections by the housing credit agency to monitor compliance with habitability standards applicable to the project.

Stacking rule -- Modifies the stacking rule so that each state is treated as using its allocation of the unused state housing credit ceiling (if any) from the preceding calendar before the current year's allocation of credit (including any credits returned to the state) and then finally any national pool allocations.

California Law (Secs. 17058 and 23610.5)

California is in conformity with federal law as it read on January 1, 1998, except that the state credit amount is 30% of the costs, is claimed over a four-year period, and is limited to projects located in California. The Tax Credit Allocation Committee is authorized to allocate up to a maximum of $50 million per year (effective for years beginning after 1999). The Committee provides listings of qualified taxpayers to the Franchise Tax Board. This credit may reduce the regular tax below the "tentative minimum tax." If the credit exceeds the tax, the excess may be carried over.

This bill would conform to the Appropriations Act, 2001, changes effective for taxable years beginning on or after January 1, 2002.

22. Extension & Modification of Enhanced Deduct. for Corporate Donations of Computer Technology

Under federal and state laws, the maximum charitable contribution deduction that may be claimed by a corporation for any one taxable year is limited to 10% of the corporation's taxable income for that year (disregarding charitable contributions and with certain other modifications). (Sec. 170(b)(2).) Corporations also are subject to certain limitations based on the type of property contributed. In the case of a charitable contribution of short-term gain property, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis (generally, cost) in the property. However, special rules in the IRC provide an augmented deduction for certain corporate contributions. Under these special rules, the amount of the augmented deduction is equal to the lesser of (1) the basis of the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold, or (2) twice the basis of the donated property.

Section 170(e)(6) allows corporate taxpayers an augmented deduction for qualified contributions of computer technology and equipment (i.e., computer software, computer or peripheral equipment, and fiber optic cable related to computer use) to be used within the United States for educational purposes in grades K-12. Eligible donees are (1) any educational organization that normally maintains a regular faculty and curriculum and has a regularly enrolled body of pupils in attendance at the place where its educational activities are regularly carried on, and (2) tax exempt charitable organizations that are organized primarily for purposes of supporting elementary and secondary education. A private foundation also is an eligible donee, provided that, within 30 days after receipt of the contribution, the private foundation contributes the property to an eligible donee described above.

Qualified contributions are limited to gifts made no later than two years after the date the taxpayer acquired or substantially completed the construction of the donated property. In addition, the original use of the donated property must commence with the donor or the donee. Accordingly, qualified contributions generally are limited to property that is no more than two years old. Such donated property could be computer technology or equipment that is inventory or depreciable trade or business property in the hands of the donor.

Donee organizations are not permitted to transfer the donated property for money or services (e.g., a donee organization cannot sell the computers). However, a donee organization may transfer the donated property in furtherance of its exempt purposes and be reimbursed for shipping, installation, and transfer costs. For example, if a corporation contributes computers to a charity that subsequently distributes the computers to several elementary schools in a given area, the charity could be reimbursed by the elementary schools for shipping, transfer, and installation costs.

The special treatment applies only to donations made by C corporations; thus, S corporations, personal holding companies, and service organizations are not eligible donors.

As originally enacted the provision was not to apply to contributions made during taxable years beginning after December 31, 1999. The IRS Restructuring and Reform Act of 1998 (P.L. 105-206) extended the provision for one year by amending the provision to not apply to contributions made during taxable years beginning after December 31, 2000.

The Appropriations Act, 2001 extended the deduction for donations of computer technology and equipment through December 31, 2003, and expands the enhanced deduction to include donations to public libraries. The Appropriations Act, 2001, provides that qualified contributions include gifts made no later than three years after the date the taxpayer acquired or substantially completed the construction of the donated property. Contributions may be made by a person that has reacquired the property (i.e., if a computer manufacturer reacquires the computer from the original user and then contributes it). Such reacquired property must be contributed within three years of the date the original construction of the property was substantially completed. Congress anticipates that for purposes of computing the enhanced deduction for a reacquirer, the Secretary will provide guidance in determining the retail value of donated computers (or other computer technology) in situations in which the number of actual retail sales of used computers similar to those donated is small in relation to the number of such computers that are donated. In addition, the Appropriations Act, 2001 provides that the Secretary may prescribe by regulation standards to ensure that the donations meet minimum functionality and suitability standards for educational purposes.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to corporate contributions of computer technology (AB 2797, Stat. 1998, Ch. 322). Thus the augmented deduction for corporate contributions of computer technology expired for taxable years beginning on or after January 1, 2000.

This bill would allow the augmented deduction for corporate contributions of computer technology in taxable years beginning on or after January 1, 2002, and contributions made through December 31, 2003.

23. Medical Savings Accounts ("MSAs")

Within limits, contributions to a medical savings account ("MSA") are deductible in determining adjusted gross income ("AGI") under federal or state laws if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an MSA are not currently taxable. Distributions from an MSA for medical expenses are not taxable. Distributions not used for medical expenses are taxable. In addition, distributions not used for medical expenses are subject to an additional 15 percent tax unless the distribution is made after age 65, death, or disability.

MSAs are available to self-employed individuals and to employees covered under an employer-sponsored high-deductible plan of a small employer. An employer is a small employer if it employed, on average, no more than 50 employees on business days during either the preceding or the second preceding year.

In order for an employee of a small employer to be eligible to make MSA contributions (or to have employer contributions made on his or her behalf), the employee must be covered under an employer-sponsored high deductible health plan (see the definition below) and must not be covered under any other health plan (other than a plan that provides certain permitted coverage).

Similarly, in order to be eligible to make contributions to an MSA, a self-employed individual must be covered under a high deductible health plan and no other health plan (other than a plan that provides certain permitted coverage). A self-employed individual is not an eligible individual (by reason of being self-employed) if the high deductible plan under which the individual is covered is established or maintained by an employer of the individual (or the individual's spouse).

The maximum annual contribution that can be made to an MSA for a year is 65% of the deductible under the high deductible plan in the case of individual coverage and 75% of the deductible in the case of family coverage.

A high deductible plan is a health plan with an annual deductible of at least $1,550 and no more than $2,350 in the case of individual coverage, and at least $3,100 and no more than $4,650 in the case of family coverage. In addition, the maximum out-of-pocket expenses with respect to allowed costs (including the deductible) must be no more than $3,100 in the case of individual coverage and no more than $5,700 in the case of family coverage. A plan does not fail to qualify as a high deductible plan merely because it does not have a deductible for preventive care as required by state law. A plan does not qualify as a high deductible health plan if substantially all of the coverage under the plan is for permitted coverage. In the case of a self-insured plan, the plan must in fact be insurance (e.g., there must be appropriate risk shifting) and not merely a reimbursement arrangement.

The number of taxpayers benefiting annually from an MSA contribution is limited to a threshold level (generally 750,000 taxpayers). If it is determined in a year that the threshold level has been exceeded (called a "cut-off" year) then, in general, for succeeding years during the four-year pilot period 1997-2000, only those individuals who (1) made an MSA contribution or had an employer MSA contribution for the year or a preceding year (i.e., are active MSA participants), or (2) are employed by a participating employer, are eligible for an MSA contribution. In determining whether the threshold for any year has been exceeded, MSAs of individuals who were not covered under a health insurance plan for the six-month period ending on the date on which coverage under a high deductible plan commences would not be taken into account. However, if the threshold level is exceeded in a year, previously uninsured individuals are subject to the same restriction on contributions in succeeding years as other individuals. That is, they would not be eligible for an MSA contribution for a year following a cut-off year unless they are an active MSA participant (i.e., had an MSA contribution for the year or a preceding year) or are employed by a participating employer. The number of MSAs established has not exceeded the threshold level.

After December 31, 2000, no new contributions may be made to MSAs except by or on behalf of individuals who previously had MSA contributions and employees who are employed by a participating employer. An employer is a participating employer if (1) the employer made any MSA contributions for any year to an MSA on behalf of employees, or (2) at least 20% of the employees covered under a high deductible plan made MSA contributions of at least $100 in the year 2000.

Self-employed individuals who made contributions to an MSA during the period 1997-2000 also may continue to make contributions after 2000.

The Appropriations Act, 2001, extends the MSA program through 2002. The same rules that apply to the limitation on MSAs for 1999 also apply to 2001 and 2002. Thus, for example, the threshold level in those years is a total of 750,000 taxpayers. The Appropriations Act, 2001, also renamed MSAs to Archer MSAs. Finally, the Congress clarifies that, as under present law, the cap and reporting requirements do not apply for 2000.

<u>California Law</u>

California is in conformity with federal law as it relates to MSAs. Section 17215 specifically provides "that the amount allowed as a deduction shall be an amount equal to the amount allowed to that individual as a deduction under Section 220 of the IRC on the federal income tax return filed for the same taxable year by that individual." Therefore, the federal MSA extension already applies for California.

This bill would affirm California's conformity to the MSA extension provision contained in the Appropriations Act, 2001.

24. Clarifying the Allowance of Certain Tax Benefits with Respect to Kidnapped Children

The IRC generally requires that a taxpayer provide over one-half of the support for each individual claimed as that taxpayer's dependent. Similarly, the child credit, the surviving spouse filing status, and the head of household filing status require that a taxpayer satisfy certain requirements with regard to individuals that qualify as the taxpayer's dependent(s). Finally, the earned income credit for taxpayers with qualifying children generally is available only if the taxpayer has the same principal place of abode for more than one-half the taxable year with an otherwise qualifying child.

Recently published IRS guidance first denied a dependency exemption to certain taxpayers with kidnapped children (TAM 200034029), then later allowed these tax benefits to such taxpayers (TAM 200038059).

The Appropriations Act, 2001, clarifies that the dependency exemption, the child credit, the surviving spouse filing status, the head of household filing status, and the earned income credit are available to an otherwise qualifying taxpayer with respect to a child who is presumed by law enforcement authorities to have been kidnapped by someone who is not a member of the family of such child or the taxpayer. Generally, this treatment continues for all taxable years ending during the period that the child is treated as kidnapped. However, this treatment ends for the taxable year ending after the calendar year in which it is determined that the child is dead (or, if earlier, in which the child would have attained age 18).

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to the definition of dependents and head of household. Thus, a kidnapped child would be allowed to be treated as a dependent under the rationale of TAM 200038059. California law does not provide an earned income or young child credit. California law has not conformed to the changes made to the IRC by the Appropriations Act, 2001.

This bill would conform to the statutory change made by the Appropriations Act, 2001, to the definition of dependents and head of household.

25. Prevention of Duplication of Loss Through Assumption of Liabilities Giving Rise to Deduction

Generally, under federal and state laws no gain or loss is recognized when one or more persons transfer property to a corporation in exchange for stock and immediately after the exchange such person or persons control the corporation. However, a transfer recognizes gain to the extent it receives money or other property ("boot") as part of the exchange (sec. 351).

The assumption of liabilities by the controlled corporation generally is not treated as boot received by the transferor, except that the transferor recognizes gain to the extent that the liabilities assumed exceed the total of the adjusted basis of the property transferred to the controlled corporation pursuant to the exchange (sec. 357(c)).

The assumption of liabilities by the controlled corporation generally reduces the transferor's basis in the stock of the controlled corporation that assumed the liabilities. The transferor's basis in the stock of the controlled corporation is the same as the basis of the property contributed to the controlled corporation, increased by the amount of any gain (or dividend) recognized by the transferor on the exchange, and reduced by the amount of any money or property received and by the amount of any loss recognized by the transferor (sec. 358). For this purpose, the assumption of a liability is treated as money received by the transferor.

An exception to the general treatment of assumption of liabilities applies to assumptions of liabilities that would give rise to a deduction, provided the incurrence of such liabilities did not result in the creation or increase of basis of any property. The assumption of such liabilities is not treated as money received by the transferor in determining whether the transferor has gain on the exchange. Similarly, the transferor's basis in the stock of the controlled corporation is not reduced by the assumption of such liabilities. The Internal Revenue Service has ruled that the assumption by an accrual basis corporation of certain contingent liabilities for soil and groundwater remediation would be covered by this exception.

The Appropriations Act, 2001, contains a provision to limit the acceleration or duplication of losses through assumption of liabilities.

Under the Appropriations Act, 2001, if the basis of stock (determined without regard to this provision) received by a transferor as part of a tax-free exchange with a controlled corporation exceeds the fair market value of the stock, then the basis of the stock received is reduced (but not below the fair market value) by the amount (determined as of the date of the exchange) of any liability that (1) is assumed in exchange for such stock, and (2) did not otherwise reduced the transferor's basis of the stock by reason of the assumption. Except as provided by the Secretary of the Treasury, this provision does not apply where the trade or business with which the liability is associated is transferred to the corporation as part of the exchange, or where substantially all the assets which the liability is associated are transferred to the corporation as part of the exchange.

The exception for transfers of a trade or business, or substantially all the assets with which a liability is associated, are intended to obviate the need for valuation or basis reduction in such cases. The exceptions are not intended to apply to a situation involving the selective transfer of assets that may bear some relationship to the liability, but that do not represent the full scope of the trade or business (or substantially all the assets) with which the liability is associated.

For purposes of this provision, the term “liability” includes fixed or contingent obligation to make payments, without regard to whether such obligation or potential obligation is otherwise taken into account under the Code. The determination whether a liability (as more broadly defined for purposes of this provision) has been assumed is made in accordance with the provisions of section 357(d)(1) of the Code. Under the standard of 357(d)(1), a recourse liability is treated as assumed if, based on all the facts and circumstances, the transferee has agreed to and is expected to satisfy such liability (or portion thereof), whether or not the transferor has been relieved of the liability. For example, if a transferee corporation does not formally assume a recourse obligation or potential obligation of the transferor, but instead agrees and is expected to indemnify the transferor with respect to all or a portion of such an obligation, then the amount that is agreed to be indemnified is treated as assumed for purposes of the provision, whether or not the transferor has been relieved of such liability. Similarly, a nonrecourse liability is treated as assumed by the transferee of any asset subject to such liability.

The application of the provision is illustrated as follows: Assume a taxpayer transfers assets with an adjusted basis and fair market value of $100 to its wholly owned corporation and the corporation assumes $40 of liabilities (the payment of which would give rise to a deduction). Thus, the value of the stock received by the transferor is $60. Under present law, the basis of the stock would be $100. The provision requires that the basis of the stock be reduced to $60 (i.e., a reduction of $40). Except as provided by the Secretary, no basis reduction is required if the transferred assets consisted of the trade or business, or substantially all of the assets, with which the liability associated.

The provision does not change the tax treatment with respect to the transferee corporation.

The Secretary of the Treasury is directed to prescribe rules providing appropriate adjustments to prevent the acceleration or duplication of losses through the assumption of liabilities (as defined in the provision) in transactions involving partnerships. The Secretary may also provide appropriate adjustments in the case of transactions involving S corporations. In the case of S corporations, such rules may be applied instead of the otherwise applicable basis reduction rules.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to transfers of property for stock to a controlled corporation. California law has not conformed to the changes made to the IRC by the Appropriations Act, 2001.

This bill would conform to the Appropriations Act, 2001, changes made to transfers of property for stock to a controlled corporation, effective for transfers made after January 1, 2002.

26. Tax Treatment Of Securities Futures Contracts

Generally, under federal and state laws, gain or loss from the sale of property, including stock, is recognized at the time of sale or other disposition of the property, unless there is a specific statutory provision of nonrecognition (sec. 1001).

Gains and losses from the sale or exchange of capital assets are subject to special rules. In the case of individuals, net capital gain is generally subject to a maximum tax rate of 20% (sec. 1(h)). Net capital gain is the excess of net long-term capital gains over net short-term capital losses. Also, capital losses are allowed only to the extent of capital gains plus, in the case of individuals, $3,000 (sec. 1211). Capital losses of individuals may be carried forward indefinitely and capital losses of corporations may be carried back three years and forward five years (sec. 1212).

Generally, in order for gains or losses on a sale or exchange of a capital asset to be long-term capital gains or losses, the asset must be held for more than one year (sec. 1222). A capital asset generally includes all property held by the taxpayer, except certain enumerated types of property such as inventory (sec. 1221).

Section 1256 Contracts

Special rules apply to “section 1256 contracts,” which include regulated futures contracts, certain foreign currency contracts, nonequity options, and dealer equity options. Each section 1256 contract is treated as if it were sold (and repurchased) for its fair market value on the last business day of the year (i.e., “marked to market”). Any gain or loss with respect to a section 1256 contract that is subject to the mark-to-market rule is treated as if 40% of the gain or loss were short-term capital gain or loss and 60% were long-term capital gain or loss. This results in a maximum rate of 27.84% on any gain for taxpayers other than corporations. The mark-to-market rule (and the special 60/40 capital treatment) is inapplicable to hedging transactions.

A “regulated futures contract” is a contract (1) which is traded on or subject to the rules of a national securities exchange registered with the Securities Exchange Commission, a domestic board of trade designated a contract market by the Commodities Futures Trading Commission, or similar exchange, board of trade, or market, and (2) with respect to which the amount required to be deposited and which may be withdrawn depends on a system of marking to market.

A “dealer equity option” means, with respect to an options dealer, an equity option purchased in the normal course of the activity of dealing in options and listed on the qualified board or exchange on which the options dealer is registered. An equity option is an option to buy or sell stock or an option the value of which is determined by reference to any stock, group of stocks, or stock index, other than an option on certain broad-based groups of stock or stock index. An options dealer is any person who is registered with an appropriate national securities exchange as a market maker or specialist in listed options, or whom the Secretary of the Treasury determines performs functions similar to market makers and specialists.

Mark to Market Accounting for Dealers in Securities

Previously, a dealer in securities computed its income from dealing in securities pursuant to the mark-to-market method of accounting (sec. 475). Gains and losses are treated as ordinary income and loss. Traders in securities, and dealers and traders in commodities may elect to use this method of accounting, including the ordinary income treatment. Section 1256 contracts are not treated as securities for purposes of section 475.

Short Sales

In the case of a “short sale” (i.e., where the taxpayer sells borrowed property and later closes the sale by repaying the lender with substantially identical property), any gain or loss on the closing transaction is considered gain or loss from the sale or exchange of a capital asset if the property used to close the short sale is a capital asset in the hands of the taxpayer, but the gain is ordinarily treated as short-term gain (sec. 1233(a)).

The Code also contains several rules intended to prevent the transformation of short-term capital gain into long-term capital gain or long-term capital loss into short-term loss by simultaneously holding property and selling short substantially identical property (sec. 1233(b) and (d)). Under these rules, if a taxpayer holds property for less than the long-term holding period and sells short substantially identical property, any gain or loss upon the closing of the short sale is considered short-term capital gain, and the holding period of the substantially identical property is generally considered to begin on the date of the closing of the short sale. Also, if a taxpayer has held property for more than the long-term holding period and sells short substantially identical property, any loss on the closing of the short sale is considered a long-term capital loss.

For purposes of these short sale rules, property includes stock, securities, and commodity futures, but commodity futures are not considered substantially identical if they call for delivery in different months.

For purposes of the short-sale rules relating to short-term gains, the acquisition of an option to sell at a fixed price is treated as a short sale, and the exercise or failure to exercise the option is considered a closing of the short sale.

The Code also treats a taxpayer as recognizing gain where the taxpayer holds appreciated property and enters into a short sale of the same or substantially identical property, or enters into a contract to sell that same or substantially identical property (sec. 1259).

Wash Sales

The wash-sale rule (sec. 1091) disallows certain losses from the disposition of stock or securities if substantially identical stock or securities (or an option or contract to acquire such property) are acquired by the taxpayer during the period beginning 30 days before the date of sale and ending 30 days after such date of sale. Commodity futures are not treated as stock or securities for purposes of this rule. The basis of the substantially identical stock or securities is adjusted to include the disallowed loss.

Similar rules apply to disallow any loss realized on the closing of a short sale of stock or securities where substantially identical stock or securities are sold (or a short sale, option or contract to sell is entered into) during the applicable period before and after the closing of the short sale.

Straddle Rules

If a taxpayer realizes a loss with respect to a position in a straddle, the taxpayer may recognize that loss for the taxable year only to the extent that the loss exceeds the unrecognized gain (if any) with respect to offsetting positions in the straddle (sec. 1092). Disallowed losses are carried forward to the succeeding taxable year and are subject to the same limitation in that taxable year.

A “straddle” generally refers to offsetting positions with respect to actively traded personal property. Positions are offsetting if there is a substantial diminution of risk of loss from holding one position by reason of holding one or more other positions in personal property. A “position” in personal property is an interest (including a futures or forward contract or option) in personal property.

The straddle rules provide that the Secretary of the Treasury may issue regulations applying the short sale holding period rules to positions in a straddle. Temporary regulations have been issued setting forth the holding period rules applicable to positions in a straddle. To the extent these rules apply to a position, the rules in section 1233(b) and (d) do not apply.

The straddle rules generally do not apply to positions in stock. However the straddle rules apply if one of the positions is stock and at least one of the offsetting positions is either (1) an option with respect to stock or (2) a position with respect to substantially similar or related property (other than stock) as defined in Treasury regulations. Under proposed Treasury regulations, a position with respect to substantially similar or related property does not include stock or a short sale of stock, but includes any other position with respect to substantially similar or related property.

If a straddle consists of both positions that are section 1256 contracts and positions that are not such contracts, the taxpayer may designate the positions as a mixed straddle. Positions in a mixed straddle are not subject to the mark-to-market rule of section 1256, but instead are subject to rules written under regulations to prevent the deferral of tax or the conversion of short-term capital gain to long-term capital gain or long-term capital loss into short-term capital loss.

Transactions by a Corporation in its Own Stock

A corporation does not recognize gain or loss on the receipt of money or other property in exchange for its own stock. Likewise, a corporation does not recognize gain or loss when it redeems its stock with cash, for more or less than it received when the stock was issued. In addition, a corporation does not recognize gain or loss on any lapse or acquisition or an option to buy or sell its stock (sec. 1032).

The Appropriations Act, 2001, provides that, except in the case of dealer securities futures contracts described below, securities futures contracts are not treated as section 1256 contracts. Thus, holders of these contracts are not subject to the mark-to-market rules of section 1256 and are not eligible for 60-percent long-term capital gain treatment under section 1256. Instead, gain or loss on these contracts will be recognized under the general rules relating to the disposition of property.

A securities futures contract is defined by reference to section 3(a)(55)(A) of the Securities Exchange Act of 1934, and is added by the Appropriations Act, 2001, to the Code. In general, that definition provides that a securities futures contract means a contract of sale for future delivery of a single security or a narrow-based security index. A securities futures contract will not be treated as a commodities futures contract for purposes of the Code.

Treatment of Gains and Losses

The Appropriations Act, 2001, provides that any gain or loss from the sale or exchange of a securities futures contract (other than a dealer securities futures contract) will be considered as gain or loss from the sale or exchange of property which has the same character as the property to which the contract relates has (or would have) in the hands of the taxpayer. Thus, if the underlying security would be a capital asset in the taxpayer's hands, then gain or loss from the sale or exchange of the securities futures contract would be capital gain or loss. The Appropriations Act, 2001, also provides that the termination of a securities futures contract that is a capital asset will be treated as a sale or exchange of the contract.

Capital gain treatment will not apply to contracts which themselves are not capital assets because of the exceptions to the definition of a capital asset relating to inventory (sec. 1221(a)(1)) or hedging (sec. 1221(a)(7)), or to any income derived in connection with a contract which would otherwise be treated as ordinary income.

Except as otherwise provided in regulations under section 1092(b) (which treats certain losses from a straddle as long term capital losses) and section 1234B, as added by the Appropriations Act, 2001, any capital gain or loss from the sale or exchange of a securities futures contract to sell property (i.e., the short side of a securities futures contract) will be short-term capital gain or loss. In other words, a securities futures contract to sell property is treated as equivalent to a short sale of the underlying property.

Wash Sale Rules

The Appropriations Act, 2001, clarifies that, under the wash sale rules, a contract or option to acquire or sell stock or securities shall include options and contracts that are (or may be) settled in cash or property other than the stock or securities to which the contract relates. Thus, for example, the acquisition, within the period set forth in section 1091, of a securities futures contract to acquire stock of a corporation could cause the taxpayer's loss on the sale of stock in that corporation to be disallowed, notwithstanding that the contract may be settled in cash.

Short Sale Rules

In applying the short sale rules, a securities futures contract to acquire property will be treated in a manner similar to the property itself. Thus, for example, the holding of a securities futures contract to acquire property and the short sale of property that is substantially identical to the property under the contract will result in the application of the rules of section 1233(b). In addition, as stated above, a securities futures contract to sell is treated in a manner similar to a short sale of the property.

Straddle Rules

Stock that is part of a straddle where at least one of the offsetting positions is a securities futures contract with respect to the stock or substantially identical stock will be subject to the straddle rules of section 1092. Treasury regulations under section 1092 applying the principles of the section 1233(b) and (d) short sale rules to positions in a straddle will also apply.

For example, assume a taxpayer holds a long-term position in actively traded stock (which is a capital asset in the taxpayer's hands) and enters into a securities futures contract to sell substantially identical stock (at a time when the position in the stock has not appreciated in value so that the constructive sale rules of section 1259 do not apply). The taxpayer has a straddle. Treasury regulations prescribed under section 1092(b) applying the principles of section 1233(d) will apply, so that any loss on closing the securities futures contract will be a long-term capital loss.

Section 1032

A corporation will not recognize gain or loss on transactions in securities futures contracts with respect to its own stock.

Holding Period

If property is delivered in satisfaction of a securities futures contract to acquire property (other than a contract to which section 1256 applies), the holding period for the property will include the period the taxpayer held the contract, provided that the contract was a capital asset in the hands of the taxpayer.

Regulations

The Secretary of the Treasury or his delegate has the authority to prescribe regulations to provide for the proper treatment of securities futures contracts under provisions of the IRC.

Dealers in Securities Futures Contracts

In general, the Appropriations Act, 2001, provides that securities futures contracts and options on such contracts are not section 1256 contracts. The Appropriations Act, 2001, provides, however, that "dealer securities futures contracts" will be treated as section 1256 contracts.

The term ''dealer securities futures contract" means a securities futures contract which is entered into by a dealer in the normal course of his or her trade or business activity of dealing in such contracts, and is traded on a qualified board of trade or exchange. The term also includes any option to enter into securities futures contracts purchased or granted by a dealer in the normal course of his or her trade or business activity of dealing in such options. The determination of who is to be treated as a dealer in securities futures contracts is to be made by the Secretary of the Treasury or his delegate not later than July 1, 2001. Accordingly, the Appropriations Act, 2001 authorizes the Secretary to treat a person as a dealer in securities futures contracts or options on such contracts if the Secretary determines that the person performs, with respect to such contracts or options, functions similar to an equity options dealer, as defined under present law.

The determination of who is a dealer in securities futures contracts is to be made in a manner that is appropriate to carry out the purposes of the provision, which generally is to provide comparable tax treatment between dealers in securities futures contracts, on the one hand, and dealers in equity options, on the other. Although traders in securities futures contracts (and options on such contracts) may not have the same market-making obligations as market makers or specialists in equity options, many traders are expected to perform analogous functions to such market makers or specialists by providing market liquidity for securities futures contracts (and options) even in the absence of a legal obligation to do so. Accordingly, the absence of market-making obligations is not inconsistent with a determination that a class of traders are dealers in securities futures contracts (and options), if the relevant factors, including providing market liquidity for such contracts (and options), indicate that the market functions of the traders is comparable to that of equity options dealers.

As in the case of dealer equity options, gains and losses allocated to any limited partner or limited entrepreneur with respect to a dealer securities futures contract will be treated as short-term capital gain or loss.

Treatment of Options Under Section 1256

The Appropriations Act, 2001, modifies the definition of “equity option” for purposes of section 1256 to take into account changes made by the non-tax provisions of the Appropriations Act, 2001. Only options dealers are eligible for section 1256 with respect to equity options. The term “equity option” is modified to include an option to buy or sell stock, or an option the value of which is determined, directly or indirectly, by reference to any stock, or any “narrow-based security index,” as defined in section 3(a)(55) of the Securities Exchange Act of 1934 (as modified by the Appropriations Act, 2001). An equity option includes an option with respect to a group of stocks only if the group meets the requirements for a narrow based security index.

As under present law, listed options that are not “equity options” are considered “nonequity options” to which section 1256 applies for all taxpayers. For example, options relating to broad-based groups of stocks and broad based stock indexes will continue to be treated as nonequity options under section 1256.

Definition of Contract Markets

The non-tax provisions of the Appropriations Act, 2001, designate certain new contract markets. The new contract markets will be contract markets for purposes of the Code, except to the extent provided in Treasury regulations.

California Law

California law is in conformity with federal law as it read on January 1, 1998, as it relates to securities futures contracts. California law has not conformed to the changes made to the IRC by the Appropriations Act, 2001.

The bill would conform to the Appropriations Act, 2001, changes to securities futures contracts.

27. Federal Technical Changes

Numerous technical changes were made to the IRC in 1998. Where California law is in conformity with the underlying federal provision affected by the technical change, this bill would conform to the technical change. The effective dates for the technical changes are either the later of the effective date for federal law or the effective date that California adopted the underlying federal law. This bill would conform to the following technical changes:

Clarification of the Deduction for Student Loan Interest (IRS Reform Act § 6004(b)). The provision clarifies that the student loan interest deduction may be claimed only by a taxpayer who is legally obligated to make the interest payments pursuant to the terms of the loan.

Clarification of Qualified State Tuition Programs (IRS Reform Act § 6004(c)). The provision clarifies that distributions from qualified state tuition programs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account.

In addition, the provision clarifies that for purposes of tax-free rollovers and changes of designated beneficiaries, a "member of the family" includes the spouse of the original beneficiary.

Clarification of Education IRAs (IRS Reform Act § 6004(d)). The provision provides that any balance remaining in an education IRA will be deemed to be distributed within 30 days after the date that the designated beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies). The provision further clarifies that, in the event of the death of the designated beneficiary, the balance remaining in an education IRA may be distributed (without imposition of the additional 10% tax) to any other (i.e., contingent) beneficiary under the age of 30 or to the estate of the deceased designated beneficiary.

If any member of the family of the deceased beneficiary becomes the new designated beneficiary of an education IRA, then no tax will be imposed on such redesignation and the account will continue to be treated as an education IRA.

The provision also clarifies that for purposes of the special rules regarding tax-free rollovers and changes of designated beneficiaries, the new beneficiary must be under the age of 30.

Under the provision, the additional 10% tax on unqualified distributions will not apply to a distribution from an education IRA, which (although used to pay for qualified higher education expenses) is includible in the beneficiary's gross income solely because the taxpayer elects to claim a HOPE or Lifetime Learning credit with respect to the beneficiary. The provision further provides that the additional 10% tax will not apply to the distribution of any contribution to an education IRA made during a taxable year if the distribution is made on or before the date that a return is required to be filed (including extensions of time) by the beneficiary for the taxable year during which the contribution was made. If the beneficiary is not required to file such a return, the return is deemed to be required on April 15th of the year following the taxable year during which the contribution was made.

In addition, the provision provides that the 10% excise tax penalty applies under that section for each year that an excess contribution remains in an education IRA (and not merely the year that the excess contribution is made).

The provision clarifies that, in order for taxpayers to establish an education IRA, the designated beneficiary must be a "life-in-being." The provision also clarifies that, under annuity rules contained in present-law IRC Sec. 72, distributions from education IRAs are treated as representing a pro-rata share of the principal (i.e., contributions) and accumulated earnings in the account.

In addition, regarding the exclusion from income of interest earned from U.S. Savings Bonds used to pay for higher education tuition and fees, the provision broadens the definition of higher education tuition and fees to conform to the definition used in education IRAs and state tuition programs.

<u>Clarification of the Enhanced Deduction for Corporate Contributions of Computer Technology and Equipment</u> (IRS Reform Act § 6004(e)). The provision clarifies the special rule applies to contributions made during taxable years beginning after December 31, 1997, and before December 31, 2000.

In addition, the provision clarifies that the requirements of "qualified elementary or secondary educational contributions" apply regardless of whether the recipient is an educational organization or a tax-exempt charitable entity.

<u>Note</u>: The revenue loss was included in AB 2797 (Stat. 1998, Ch. 322) as if the enhanced deduction for the computer technology and equipment was available to corporations for income years beginning after December 31, 1997, and before January 1, 2001. A $4 million loss was attributed to that bill.

<u>Clarification of the Cancellation of Certain Student Loans</u> (IRS Reform Act § 6004(f)). The provision clarifies that gross income does not include amounts from the forgiveness of loans made by educational organizations and certain tax-exempt organizations to refinance any existing student loan (and not just loans made by educational organizations).

In addition, the provision clarifies that refinancing loans made by educational organizations and certain tax-exempt organizations must be made pursuant to a program of the refinancing organization (e.g., school or private foundation) that requires the student to fulfill a public service work requirement.

<u>Clarification of Limitations for Active Participation in an IRA</u> (IRS Reform Act § 6005(a)). The provision clarifies the intent of the Tax Relief Act of 1997 relating to the AGI phase-out ranges for married individuals who are active participants in employer-sponsored plans and the AGI phase-out range for spouses of such active participants.

Clarification of the Penalty-Free Distributions for Education Expenses and Purchase of First Homes (IRS Reform Act § 6005(c)). The provision modifies the rules relating to the ability to roll over hardship distributions from certain employer-sponsored retirement plans to prevent avoidance of the 10% early withdrawal tax.

Distributions from cash or deferred arrangements and similar arrangements made on account of hardship of the employee are not eligible rollover distributions. Such distributions will not be subject to the 20% withholding applicable to eligible rollover distributions.

Rollover of Gain from Sale of Qualified Stock (IRS Reform Act § 6005(f)). Under the provision, a partnership or an S corporation can roll over gain from qualified small business stock held more than six months only if at all times during the taxable year all the interests in the partnership or S corporation are held by individuals, estates, and trusts with no corporate beneficiaries. The term "estate" is intended to include both the estate of a decedent and the estate of an individual in bankruptcy.

The provision also provides that the benefit of a tax-free rollover with respect to the sale of small business stock by a partnership will flow through to a partner who is not a corporation if the partner held its partnership interest at all times the partnership held the small business stock. A similar rule applies to S corporations.

Election to Use AMT Depreciation for Regular Tax Purposes (IRS Reform Act § 6006(b)). For property placed in service after 1998, a taxpayer is allowed to elect, for regular tax purposes, to compute depreciation on tangible personal property otherwise qualified for the 200% declining balance method by using the 150% declining balance method over the recovery periods applicable to the regular tax (rather than the longer class lives of the alternative depreciation system (ADS) of IRC Sec. 168(g)).

Depreciation Limitations for Electric Vehicles (IRS Reform Act § 6009(c)). Annual depreciation deductions with respect to passenger automobiles are limited to specified dollar amounts, indexed for inflation. Any cost not recovered during the six-year recovery period (the recovery period) of such vehicles may be recovered during the years succeeding the recovery period, subject to similar limitations.

Current law provides the recovery period limitations are trebled for vehicles that are propelled primarily by electricity.

The provision provides that the depreciation limitations applicable to post-recovery periods under IRC Sec. 280F are trebled for vehicles that are propelled primarily by electricity.

Clarification of Constructive Sales Rules (IRS Reform Act § 6010(a)). The provision clarifies that, to qualify for the exception for positions with respect to debt instruments, the position would either have to meet the requirements as to unconditional principal amount, non-convertibility and interest terms or, alternatively, be a hedge of a position meeting these requirements. A hedge for purposes of the provision includes any position that reduces the taxpayer's risk of interest rate or price changes or currency fluctuations with respect to another position.

The provision also clarifies that the definition of a forward contract includes a contract that provides for cash settlement with respect to a substantially fixed amount of property at a substantially fixed price.

Additionally, the provision clarifies that the special effective date rule does not apply if the constructive sale transaction is closed at any time prior to the end of the 30th day after the date of enactment of the Tax Relief Act of 1997.

Treatment of Mark-to-Market Gains of Electing Traders (IRS Reform Act § 6010(a)). The provision clarifies that gain or loss of a securities or commodities trader that is treated as ordinary solely by reason of election of mark-to-market treatment is not treated as other than gain or loss from a capital asset for purposes of determining “net earnings from self-employment” for the Self-Employed Contributions Act tax purposes, determining whether the passive-type income exception to the publicly-traded partnership rules is met, or for purposes of any other IRC provision specified by the Treasury Department in regulations.

Treatment of Certain Corporate Distributions (IRS Reform Act § 6010(c)). The provision clarifies that the acquisitions described in IRC Sec. 355(e)(3)(A) are disregarded in determining whether there has been an acquisition of a 50% or greater interest in a corporation. However, other transactions that are part of a plan or series of related transactions could result in an acquisition of a 50% or greater interest.

In the case of acquisitions under IRC Sec. 355(e)(3)(A)(iv), the provision clarifies that the acquisition of stock in the distributing corporation or any controlled corporation is disregarded to the extent that the percentage of stock owned directly or indirectly in the corporation by each person owning stock in the corporation immediately before the acquisition does not decrease.

Certain Preferred Stock Treated as "Boot" (IRS Reform Act § 6010(e)). The provision provides that the statutory period for the assessment of any deficiency attributable to a corporation failing to be a family-owned corporation shall not expire before the expiration of three years after the date the Secretary of the Treasury is notified by the corporation (in such manner as the Secretary may prescribe) of such failure, and such deficiency may be assessed before the expiration of such three-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

The provision also clarifies that IRC Sec. 351(b), relating to the receipt of property, applies to a transferor who transfers property in an IRC Sec. 351 exchange and receives nonqualified preferred stock in addition to stock that is not treated as "other property" under that section. Thus, if a transferor received only nonqualified preferred stock but the transaction in the aggregate otherwise qualified as an IRC Sec. 351 exchange, such a transferor would recognize loss and the basis of the nonqualified preferred stock and of the property in the hands of the transferee corporation would reflect the transaction in the same manner as if that particular transferor had received solely "other property" of any other type.

Modify UBI Rules Applicable to Second-Tier Subsidiaries (IRS Reform Act § 6010(j). The provision clarifies that rent, royalty, annuity, and interest income that would otherwise be excluded from "unrelated business income" (UBI) is included in UBI if such income is received or accrued from a taxable or tax-exempt subsidiary that is controlled by the parent tax-exempt organization. The provision further clarifies that the provision does not apply to any payment received or accrued during the first two taxable years beginning on or after the date of enactment if such payment is received or accrued pursuant to a binding written contract in effect on June 8, 1997, and at all times thereafter before such payment (but not pursuant to any contract provision that permits optional accelerated payments).

Clarification of Allocation of Basis of Properties Distributed to a Partner by a Partnership (IRS Reform Act § 6010(m)). The technical correction clarifies that for purposes of the allocation rules of IRC Sec. 732(c), "unrealized receivables" has the meaning in IRC Sec. 751(c) including the last two sentences of IRC Sec. 751(c), relating to items of property that give rise to ordinary income. Thus, in applying the allocation rules of IRC Sec. 732(c) to property listed in the last two sentences of IRC Sec. 751(c), such as property giving rise to potential depreciation recapture, the amount of unrealized appreciation in any such property does not include any amount that would be treated as ordinary income if the property were sold at fair market value, because such amount is treated as a separate asset for purposes of the basis allocation rules.

Clarification of Expanding the Limitations on Deductibility of Premiums and Interest with Respect to Life Insurance, Endowment and Annuity Contracts (IRS Reform Act § 6010(o)). The technical correction clarifies that if coverage for each insured individual under a master contract is treated as a separate contract for purposes of IRC Sec. 817(h), 7702, and 7702A, then coverage for each such insured individual is treated as a separate contract for purposes of the exception to the pro rata interest disallowance rule for a policy or contract covering an individual who is a 20% owner, employee, officer or director of the trade or business at the time first covered. A master contract does not include any contract if the contract (or any insurance coverage provided under the contract) is a group life insurance contract within the meaning of IRC Sec. 848(e)(2). No inference is intended that coverage provided under a master contract, for each such insured individual, is not treated as a separate contract for each such individual for other purposes under present law.

The technical correction clarifies that the required reporting to the Treasury Secretary is an information return and any reporting required to be made to any other person is a payee statement.

Thus, the $50-per-report penalty imposed for failure to file or provide such an information return or payee statement applies. It is clarified that the Treasury Secretary may require reporting by the issuer or policyholder of any relevant information either by regulations or by any other appropriate guidance (including but not limited to publication of a form).

The technical correction clarifies that the treatment of additional covered lives under the effective date of the TRA of 1997 provision applies only with respect to coverage provided under a master contract, provided that coverage for each insured individual is treated as a separate contract for purposes of IRC Sec. 817(h), 7702 and 7702A, and the master contract or any coverage provided thereunder is not a group life insurance contract within the meaning of IRC Sec. 848(e)(2).

<u>Information Reporting with Respect to Certain Foreign Corporations and Partnerships</u> (IRS Reform Act § 6011(f)). The provision provides clarification and guidance relating to the furnishing of required information to be provided by the Secretary of the Treasury (not specifically through regulations) and conforms the use of the defined term "foreign business entity."

<u>Travel Expenses of Federal Employees Participating in a Federal Criminal Investigation</u> (IRS Reform Act § 6012(a)). The provision clarifies that prosecuting a federal crime or providing support services to the prosecution of a federal crime is considered part of investigating a federal crime, thus permitting these employees to deduct their travel expenses.

<u>Modification of Distribution Rules for REITs</u> (IRS Reform Act § 6012(g)). The provision amends the simplification provision to provide that any distribution from a REIT will be deemed to first come from earnings and profits that were generated when the entity did not qualify as a REIT. The provision does not change the requirement that a REIT must distribute 95% of its REIT earnings, or any other requirement.

<u>Provision of Regulatory Authority for Simplified Reporting of Funeral Trusts Terminated During the Taxable Year</u> (IRS Reform Act § 6013(b)). The provision clarifies that a pre-need funeral trust may continue to qualify for these special rules for the 60-day period after the decedent's death, even though the trust ceases to be a grantor trust during that time.

<u>Treatment of Certain Disability Payments to Public Safety Employees</u> (IRS Reform Act § 6015(c)). In order to address problems taxpayers are encountering with the IRS in seeking refunds under the old provision, the new provision clarifies the scope of the provision.

The provision provides that payments made on account of heart disease or hypertension of the employee received in 1989, 1990, or 1991 pursuant to a state law as described under present law, or received by an individual referred to in the state law under any other statute, ordinance, labor agreement, or similar provision as a disability pension payment or in the nature of a disability pension payment attributable to employment as a police officer or as a fireman, will be excludable from income.

<u>Application of Requirements for SIMPLE IRAs in the Case of Mergers and Acquisitions</u> (IRS Reform Act § 6016(a)). The provision conforms the treatment applicable to SIMPLE IRAs upon acquisition, disposition or similar transactions for purposes of (1) the 100 employee limit, (2) the exclusive plan requirement, and (3) the coverage rules for participation.

In the event of such a transaction, the employer will be treated as an eligible employer and the arrangement will be treated as a qualified salary reduction arrangement for the year of the transaction and the two following years, provided rules similar to the rules of IRC Sec. 410(b)(6)(C)(i) are satisfied and the arrangement would satisfy the requirements to be a qualified salary reduction arrangement after the transaction if the trade or business that maintained the arrangement prior to the transaction had remained a separate employer.

Treatment of Indian Tribal Governments (IRS Reform Act § 6016(a)). The provision clarifies that an employee participating in an IRC Sec. 403(b)(7) custodial account of the Indian tribal government may roll over amounts from such account to an IRC Sec. 401(k) plan maintained by the Indian tribal government.

Disclosure of Returns and Return Information (IRS Reform Act § 6019(c)). The provision clarifies that disclosures to one ex or estranged spouse, whether there has been an attempt to collect the deficiency from the other ex or estranged spouse, that, like certain other disclosures permitted under present law, may be made to the duly authorized attorney in fact of the person making the disclosure request.

Treatment of Interest on Qualified Education Loans (Trade and Extenders Act § 4003(a)). The provision clarifies that otherwise deductible qualified education loan interest is not treated as nondeductible personal interest. The provision also clarifies that, for purposes of phasing out the deduction, modified AGI is determined after application of IRC Sec. 135 (relating to income from certain U.S. savings bonds) and IRC Sec. 137 (relating to adoption assistance programs).

The provision also provides that a qualified education loan does not include any indebtedness owed to any person by reason of a loan under any qualified employer plan or under any contract purchased under a qualified employer plan.

Abatement of Interest by Reason of Presidentially Declared Disasters (Trade and Extenders Act § 4003(e)). Under a provision of the TRA of 1997, if the Secretary of the Treasury extends the filing date of an individual tax return for individuals living in an area that has been declared a disaster area by the President during 1997, no interest is charged as a result of the failure of the individual taxpayer to file an individual tax return, or to pay the taxes shown on such return, during the extension period. The 1998 provision extends the rule so that it is available for disasters declared in 1997 or 1998 with respect to the 1997 tax year.

Determination of Unborrowed Policy Cash Value Under COLI Pro Rata Interest Disallowance Rules (Trade and Extenders Act § 4003(i)). The provision clarifies the meaning of "unborrowed policy cash value" with respect to any life insurance, annuity or endowment contract.

The technical correction clarifies that if the cash surrender value (determined without regard to any surrender charges) with respect to any policy or contract does not reasonably approximate its actual value, then the amount taken into account for this purpose is the greater of (1) the amount of the insurance company's liability with respect to the policy or contract, as determined for purposes of the annual statement approved by the National Association or Insurance Commissioners, (2) the amount of the insurance company's reserve with respect to the policy or contract for purposes of such annual statement; or (3) such other amount as is determined by the Treasury Secretary.

Casualty Loss Deductions (Trade and Extenders Act § 4004). The provision clarifies that all deductions for nonbusiness casualty and theft losses are taken into account in computing an NOL. Also, these deductions are not treated as miscellaneous itemized deductions subject to the 2% adjusted gross income floor, or as itemized deductions subject to the overall limitation on itemized deductions, and are allowed to nonresident aliens.

Technical Amendments Made by the Appropriations Act, 2001, Relating to the Ticket to Work and Work Incentives Improvement Act of 1999

Research credit. The provision clarifies the anti-double dip rule coordinating the research credit (sec. 41) and the Puerto Rico economic activity credit (sec. 30A). It is arguable that the present-law provisions could be construed so that the amount of wages on which a taxpayer could claim the section 30A credit is reduced only by the amount of credit claimed under section 41, rather than by the amount of wages upon which the section 41 credit is based. This result is inconsistent with the legislative history of the original provisions. The provision deletes the words “or credit” after “deduction” in section 280C(c)(1), and adds a new subsection in section 30A specifying that wages or other expenses taken into account for section 30A may not be taken into account for section 41.

Taxable REIT subsidiaries. The provision clarifies that a REIT’s redetermined rents (described in sec. 857(b)(7)(B)) that are subject to tax under section 857(b)(7)(A) do not include amounts received from a taxable REIT subsidiary that would be excluded from unrelated business taxable income (under sec. 512(b)(3), relating to certain rents, if received by certain types of organizations described in sec. 511(a)(2)).

Partnership basis adjustments. The provision provides that the rule in the consolidated return regulations (Treas. Reg. sec. 1.1502-34) aggregating stock ownership for purposes of section 332 (relating to complete liquidation of a subsidiary that is a controlled corporation) also applies for purposes of section 732(f) (relating to basis adjustments to assets of a controlled corporation received in a partnership distribution).

Technical Amendments Made by the Appropriations Act, 2001, Related to the Taxpayer Relief Act of 1997

Straight-line depreciation under AMT. The provision clarifies that the Taxpayer Relief Act of 1997 did not change the requirement that the straight-line method of depreciation be used in computing the alternative minimum tax (“AMT”) depreciation allowance for section 1250 property. It is arguable that the changes made by Taxpayer Relief Act could be read as inadvertently allowing accelerated depreciation under the AMT for section 1250 property that is allowed accelerated depreciation under the regular tax.

Transportation benefits. Salary reduction amounts are generally treated as compensation for purposes of the limits on contributions and benefits under qualified plans. In addition, an employer can elect whether or not to include such amounts for nondiscrimination testing purposes. The IRS Reform Act permitted employers to offer a cash option in lieu of qualified transportation benefits. The Appropriations Act, 2001, treats salary reduction amounts used for qualified transportation benefits the same as other salary reduction amounts for purposes of defining compensation under the qualified plan rules.

Technical Amendments Made by the Appropriations Act, 2001, Related to the Small Business Job Protection Act of 1996

Electing small business trusts holding S corporation stock. The provision allows an electing small business trust (sec. 1361(e)) to have an organization described in section 170(c)(1) (relating to state and local governments) as a beneficiary if the organization holds a contingent interest and is not a potential current beneficiary.

Definition of lump-sum distribution. Section 1401(b) of the Small Business Job Protection Act of 1996 Act repealed five-year averaging for lump-sum distributions. The definition of lump-sum distribution was preserved for other provisions, primarily those relating to certain arrangements in employer securities. The definition was moved from section 402(d)(4)(A) to section 402(e)(4)(D)(i). This definition included the following sentence: “A distribution of an annuity contract from a trust or annuity plan referred to in the first sentence of this subparagraph shall be treated as a lump sum distribution.” The Appropriations Act, 2001, adds this language back into the definition of lump-sum distribution. The sentence is relevant to section 401(k)(1)(B), which permits certain distributions if made as a “lump-sum distribution.”

IRAs for nonworking spouses. Section 1427 of the Small Business Job Protection Act of 1996 expanded the IRA deduction for nonworking spouses. The maximum permitted IRA contribution is generally limited by the individual’s earned income. Previously, it was possible for a nonworking (or lesser earning) spouse to make IRA contributions in excess of the couple’s combined earned income. The following example illustrates previous law.

Example: Suppose H and W retire in the middle of January 1999. In that year, H earns $1,000 and W earns $500. Both are active participants in an employer-sponsored retirement plan. Their modified AGI is $60,000. They make no Roth IRA contributions. Before application of the income phase-out rules, the maximum deductible IRA contribution that H can make is $1,000 (sec. 219(b)(1)). After application of the income phase-out rule in section 219(g), H's maximum contribution is $200, and H contributes that amount to an IRA. Under 408(o)(2)(B), H can make nondeductible contributions of $800 ($1,000-$200).

W's maximum permitted deductible contribution under section 219(c)(1)(B), before the income phase-out, is $1,300 (the sum of H and W's earned income ($1,500) less H's deductible IRA contribution ($200)). Under the income phase-out, W's deductible contribution is limited to $200, and she can make a nondeductible contribution of $1,100 ($1,300-$200).

The total permitted contributions for H and W are $2,400 ($1,100 for H plus $1,300 for W). The combined contribution should have been limited to $1,500, the combined earned income of the spouses.

The Appropriations Act, 2001, provides that the contributions for the spouse with the lesser income cannot exceed the combined earned income of both spouses.

Technical Amendments Made by the Appropriations Act, 2001, Related to the Revenue Reconciliation Act of 1990

Qualified tertiary injectant expenses. The provision clarifies that the enhanced oil recovery credit (sec. 43) applies with respect to qualified tertiary injectant expenses described in section 193(b) that are paid or incurred in connection with a qualified enhanced oil recovery project, and that are deductible for the taxable year (regardless of the provision allowing the deduction). Purchased and self-produced injectants are treated the same for purposes of the section 43 credit.

Technical Amendments Made by the Appropriations Act, 2001, to Other Acts

Insurance. The legislative history of section 7702A(a) (enacted in the Technical and Miscellaneous Revenue Act of 1988) indicated that if a life insurance contract became a modified endowment contract ("MEC"), then the MEC status could not be eliminated by exchanging the MEC for another contract. Section 7702A(a)(2), however, arguably might have been read to allow a policyholder to exchange a MEC for a contract that does not fail the seven-pay test of section 7702A(b), then exchange the second contract for a third contract, which would not literally have been received in exchange for a contract that failed to meet the seven-pay test. The Appropriations Act, 2001 clarifies section 7702A(a)(2) to correspond to the legislative history, effective as if enacted with the Technical and Miscellaneous Revenue Act of 1988 (generally, for contracts entered into on or after June 21, 1988).

Insurance. Under section 7702A, if a life insurance contract that is not a modified endowment contract is actually or deemed exchanged for a new life insurance contract, then the seven-pay limit under the new contract is first computed without reference to the premium paid using the cash surrender value of the old contract. Then, it would be reduced by 1/7 of the premium paid taking into account the cash surrender value of the old contract.

For example, if the old contract had a cash surrender value of $14,000 and the seven-pay premium on the new contract would equal $10,000 per year but for the fact that there was an exchange, the seven-pay premium on the new contract would equal $8,000 ($10,000-$14,000/7). However, section 7702A(c)(3)(A) arguably might have been read to suggest that if the cash surrender value on the new contract was $0 in the first two years (due to surrender charges), then the seven-pay premium might be $10,000 in this example, unintentionally permitting policyholders to engage in a series of “material changes” to circumvent the premium limitations in section 7702A. The Appropriations Act, 2001, clarifies section 7702A(c)(3)(A) to refer to the cash surrender value of the old contract, effective as if enacted with the Technical and Miscellaneous Revenue Act of 1988 (generally, for contracts entered into on or after June 21, 1988).

Worthless securities. Section 165(g)(3) provides a special rule for worthless securities of an affiliated corporation. The test for affiliation in section 165(g)(3)(A) is the 80 percent vote test for affiliated groups under section 1504(a) that was in effect prior to 1984. When section 1504(a) was amended in the Deficit Reduction Act of 1984 to adopt the vote and value test of present law, no corresponding change was made to section 165(g)(3)(A), even though the tests had been identical until then. The Appropriations Act, 2001, conforms the affiliation test of section 165(g)(3)(A) to the test in section 1504(a)(2), effective for taxable years beginning after December 31, 1984.

Exception for certain annuities under OID rules. The Deficit Reduction Act of 1984 expanded the prior law rules for inclusion in income of original issue discount (“OID”) on debt instruments. It provided an exception from the definition of a debt instrument for certain annuity contracts, including any annuity contract to which section 72 applies and that is issued by an insurance company subject to tax under subchapter L of the Code (and that meets certain other requirements). (See sec. 1275(a)(1)(B)(ii).) The Appropriations Act, 2001, clarifies that an annuity contract otherwise meeting the applicable requirements also comes within the exception of section 1275(a)(1)(B)(ii) if it is issued by an entity described in section 501(c) and exempt from tax under section 501(a), that would be subject to tax as an insurance company under subchapter L if it were not exempt under section 501(a).

For example, the Appropriations Act, 2001 clarifies that an annuity contract otherwise meeting the requirements that is issued by a fraternal beneficiary society which is exempt from federal income tax under section 501(a), and which is described in section 501(c)(8), comes within the exception under section 1275(a)(1)(B)(ii). It is understood that charitable gift annuities (as defined in sec. 501(m)) depend (in whole or in substantial part) on the life expectancy of one or more individuals, and thus come within the exception under section 1275(a)(1)(B)(i). This provision is effective as if included with section 41 of the Deficit Reduction Act of 1984 (i.e., for taxable years ending after July 18, 1984).

28. Technical Amendments

This bill would make eight technical amendments to the Revenue and Taxation Code. Two of the technical amendments remove obsolete IRC references relating to installment sales, one adds a Corporations Code reference relating to penalties, two of the amendments relate to involuntary conversions and are clean-up to SB 519 (Stat. 1998, Ch. 7), two amendments update cross-references in the CTL, and one amendment updates state conformity to a federal technical change to the rules for electing 1987 partnerships. No revenue is associated with any of these “code maintenance” technical amendments.